

BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

LeRoy Koppendraye
Marshall Johnson
Ken Nickolai
Thomas Pugh
Phyllis A. Reha

Chair
Commissioner
Commissioner
Commissioner
Commissioner

In the Matter of the Application of Northern
States Power Company d/b/a Xcel Energy for
Authority to Increase Rates for Electric Service
in Minnesota

ISSUE DATE: September 1, 2006

DOCKET NO. E-002/GR-05-1428

FINDINGS OF FACT, CONCLUSIONS OF
LAW, AND ORDER; ORDER OPENING
INVESTIGATION

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PROCEDURAL HISTORY

I. Initial Filings

On November 2, 2005, Northern States Power Company d/b/a Xcel Energy (Xcel or the Company) filed a general rate case under Minn. Stat. § 216B.16, proposing to increase its rates for electric service by approximately 8%, or \$168,047,000.

On December 30, 2005, the Commission issued two orders finding the rate case filing substantially complete, suspending the proposed rates, and referring the case to the Office of Administrative Hearings for contested case proceedings. On the same date, the Commission issued its *Order Setting Interim Rates*, authorizing the Company to collect an across-the-board interim rate increase of \$147,318,000 per year, or approximately 7.25%, for service rendered on or after January 1, 2006. Interim rates are collected subject to refund under Minn. Stat. § 216B.16, subd. 3.

II. The Parties and Their Representatives

The following parties filed testimony or memoranda in this case:

- Xcel Energy, represented by Megan J. Hertzler and James Johnson, Assistant General Counsels, 414 Nicollet Mall, Fifth Floor, Minneapolis, Minnesota 55401; and Richard J. Johnson, Michael J. Bradley, and Dan Lipschultz, Moss & Barnett, 4800 Wells Fargo Center, 90 South Seventh Street, Minneapolis, Minnesota 55402.
- The Minnesota Department of Commerce (the Department), represented by Julia E. Anderson and Linda S. Jensen, Assistant Attorneys General, 445 Minnesota Street, Suite 1400, St. Paul, Minnesota 55101.
- The Residential and Small Business Utilities Division of the Office of the Attorney General (RUD-OAG), represented by Ronald M. Giteck and Steve Alpert, Assistant Attorneys General, 445 Minnesota Street, Suite 900, St. Paul, Minnesota 55101.

- The Suburban Rate Authority, represented by Bryan Shirley, Kennedy & Graven, 470 U.S. Bank Plaza, 200 South Sixth Street, Minneapolis, Minnesota 55402.
- Ford Motor Company, Gerdau AmeriSteel US, Inc., and Marathon Ashland Petroleum LLC (appearing jointly as the Large Industrials), represented by Robert S. Lee and Andrew P. Moratzka, Mackall, Crounse & Moore, 1400 AT&T Tower, 901 Marquette Avenue, Minneapolis, Minnesota 55402.
- Excelsior Energy, Inc., represented by Scott G. Harris, Leonard, Street and Deinard, 150 South Fifth Street, Suite 2300, Minneapolis, Minnesota 55402.
- A consortium of commercial customers, appearing jointly as the Commercial Group, and consisting of the Minnesota locations of Lowe's Home Centers, Inc.; Wal-Mart Stores East, LP; Big Lots Stores, Inc; Best Buy Co., Inc.; Federated Department Stores, Inc.; and Kohl's Department Stores, Inc., represented by Alan R. Jenkins, McKenna Long & Aldridge, 303 Peachtree Street Northeast, Suite 5300, Atlanta, Georgia 30308.
- The Minnesota Chamber of Commerce, represented by Bradley Hendrikson and Richard J. Savelkoul, Felhaber, Larson, Fenlon & Vogt, 444 Cedar Street, Suite 2100, St. Paul, Minnesota 55101.
- The Energy CENTS Coalition, represented by Pam Marshall and Chris Duffrin, 823 East Seventh Street, St. Paul, Minnesota 55106.
- Myer Shark, Esq., Suite 221, 3630 Phillips Parkway, St. Louis Park, Minnesota 55426, who appeared for himself.
- The Board of Water Commissioners of the City of Saint Paul, represented by Lisa L. Veith, Senior Assistant City Attorney, 400 City Hall, 15 West Kellogg Boulevard, St. Paul, Minnesota 55102.
- The Metropolitan Counties Energy Task Force, represented by Peter H. Grills, Esq., W2800 First National Bank Building, 332 Minnesota Street, St. Paul, Minnesota 55101.

The following persons intervened but did not actively participate: Legal Services Advocacy Project, Minnesota Power, Otter Tail Corporation, d/b/a Otter Tail Power Company, and International Paper Corporation. Three parties withdrew from the proceeding: International Brotherhood of Electrical Workers, Local Union 23; International Brotherhood of Electrical Workers, Local Union 949; and Rebecca Winegarten.

III. Proceedings Before the Administrative Law Judge (ALJ)

The Office of Administrative Hearings assigned Administrative Law Judge Kathleen D. Sheehy to hear this case.

A. Evidentiary Hearings

Parties filed direct, rebuttal, and surrebuttal testimony in writing, and Judge Sheehy held evidentiary hearings, primarily for purposes of cross-examination and clarification, from April 20-27, 2006.

Parties also conducted extensive discovery, held settlement discussions, and filed initial and reply post-hearing briefs.

The parties worked effectively to narrow the issues and ultimately resolved all but 18 issues, either through settlement or by taking the same positions at hearing.

B. Public Hearings

The ALJ held public hearings at the following locations between March 3, 2006 and April 20, 2006:

- Minneapolis Community and Technical College
- St. Clair Recreation Center, St. Paul
- Prom Center, Oakdale
- Winona City Hall
- Intergovernmental Center, Mankato
- Stearns County Courthouse, St. Cloud, with video-conference links to Moorhead and Maple Grove
- Chippewa County Government Center, Montevideo
- Public Utilities Commission Offices, St. Paul

Some 111 members of the public attended the public hearings, and 46 members of the public submitted written comments, addressing a wide range of issues. The Administrative Law Judge reported that public comments focused on the following areas: total household energy expense; impact of energy costs on fixed-income and low-income customers; the allocation of the revenue requirement among customer classes; the amount of the fixed monthly charge for residential customers; increasing reliance on renewable generation resources; the comparative fuel costs of different generation technologies; executive compensation; the tax consequences, and any resulting rate consequences, of the bankruptcy of Xcel's unregulated affiliate, NRG; investors' expectations of a fair return on investment; and service quality.

IV. Proceedings Before the Commission

On July 6, 2006, the Administrative Law Judge filed her Findings of Fact, Conclusions, and Recommendation (the ALJ's Report).

On July 21, 2006, the Company, the Department, the RUD-OAG, the Chamber of Commerce, and Myer Shark filed exceptions to the report of the Administrative Law Judge.

On July 31, 2006, the Chamber of Commerce and the Commercial Group filed replies to exceptions.

On August 10 and 14, 2006, the Commission held oral argument, and the record closed under Minn. Stat. § 14.61, subd. 2 on August 14.

Having examined the entire record herein and having heard the arguments of the parties, the Commission makes the following findings, conclusions, and order.

FINDINGS AND CONCLUSIONS

I. The Legal Standard

Under the Public Utilities Act, utilities seeking a rate increase have the burden of proof to show that the proposed rate change is just and reasonable. Minn. Stat. § 216B.16, subd. 4. Any doubt as to reasonableness is to be resolved in favor of the consumer. Minn. Stat. § 216B.03.

The Act requires the Commission to set rates to encourage conservation and renewable energy use “to the maximum reasonable extent.” Minn. Stat. § 216B.03. The Commission is permitted to consider ability to pay as a factor in setting utility rates and is authorized to establish programs to ensure affordable, reliable, and continuous service to low-income residential ratepayers. Minn. Stat. § 216B.16, subd. 15.

The Act also encourages settlements. Before beginning contested case proceedings on a general rate case, Administrative Law Judges are required to convene a settlement conference for the purpose of encouraging settlement of some or all of the issues in the case. They are authorized to reconvene the settlement conference at any point before the case is returned to the Commission, at their own discretion or at the request of any party. Minn. Stat. § 216B.16, subd. 1a (a).

The Commission is authorized to accept, reject, or modify any settlement. It can accept a settlement only upon finding that to do so is in the public interest and is supported by substantial evidence. Minn. Stat. § 216B.16, subd. 1a (b).

While the Commission recognizes that compromise is a key ingredient of any settlement, it also recognizes that resolving disputed issues in rate cases is fundamentally different from resolving disputes between private litigants:

In deciding whether to accept the Offer of Settlement, the Commission must apply a different standard than is normally used by the courts. Unlike the traditional function of civil courts, the Commission’s primary function is not to resolve disputes between litigants. Instead, it is an affirmative duty to protect the public interest by ensuring just and reasonable rates.

In the Matter of a Petition by the U.S. Department of Defense, the General Services Administration, and All Other Federal Executive Agencies of the United States Challenging the Reasonableness of the Rates Charged by Northwestern Bell Telephone Company, Docket No. P-421/CI-86-354, ORDER ACCEPTING OFFER OF SETTLEMENT (February 10, 1988) at 3.

Because rate case decisions can have far-reaching consequences for persons who were not at the negotiating table, the Commission has long required settling parties to document that all issues have been settled within the zone of regulatory reasonableness:

In non-ratemaking settlement negotiations it is common for parties to concede some issues to obtain a more favorable resolution of others they value more highly. This is reasonable and appropriate in private disputes, where the goal of the settlement process is to reach a result satisfactory to all parties. In Commission proceedings, however, the goal of the process is to serve the public interest.

This requires protecting the interests of the Company, the public, and all customer classes, whether or not their interests are vigorously represented. It requires resolving every issue within the bounds of acceptable regulatory practice, since future rate structures are built on the foundations established in past rate cases. For these reasons the Commission scrutinizes settlements with care and requires documentation of the reasonableness of the disposition of all issues.

In the Matter of the Application of Interstate Power Company for Authority to Change its Rates for Natural Gas Service in the State of Minnesota, Docket No. G-001/GR-90-700, ORDER ACCEPTING AND ADOPTING STIPULATION AND OFFER OF SETTLEMENT (June 27, 1991), at 6-7.

II. Summary of the Issues

As discussed above, the parties were successful in narrowing the issues and ultimately litigated only 18 issues, listed below:

- (1) **Flint Hills Revenues** – Should rates be adjusted to reflect the increased revenues that will result from the return of Xcel’s largest customer, Flint Hills Resources LLC, the day after the projected test year ends?
- (2) **Post-Retirement Medical Benefits** – What are the appropriate test year costs for Xcel’s post-retirement medical benefits program?
- (3) **Severe Storm/Tree Trimming Costs** – Should Xcel be granted rate recovery to establish a \$2,000,000 severe storm reserve fund or, alternatively, recover an additional \$2,000,000 in tree trimming/vegetation management costs?
- (4) **Incentive Compensation** – What is the appropriate test year expense and accounting treatment for incentive compensation for Xcel employees?
- (5) **Amortization Period for Investment in Nuclear Waste Storage Facility** – What is the appropriate amortization period for the Company’s investment in seeking to develop a private, nuclear waste storage facility to comply with a legislative directive that it seek out-of-state storage for nuclear waste?
- (6) **Time-of-Use Pilot Project Expense** – Should the Company be granted rate recovery of deferred expenses incurred to comply with Commission directives to establish a residential time-of-use pilot project?
- (7) **Income Tax Recovery** – Should Xcel be granted rate recovery of an income tax liability that was ultimately offset by losses in a consolidated tax return?
- (8) **Return on Equity** – What is a just and reasonable return on equity for Xcel’s shareholders?
- (9) **Overall Rate of Return** – What is a just and reasonable overall rate of return?
- (10) **Class Cost of Service Study** – Is the Company’s Class Cost of Service Study reasonable and acceptable for ratemaking purposes?

- (11) **Inter-Class Revenue Responsibility** – How should responsibility for meeting the revenue requirement be allocated among the customer classes?
- (12) **Fuel Clause Adjustments** – Should Xcel be permitted to use a refined class cost allocation tool in calculating fuel clause adjustments, to combine fuel-related line items on customer bills, and to make other miscellaneous changes to the operation of the fuel clause?
- (13) **Dual Feeder Service Rates** – Should Xcel be permitted to raise rates for dual feeder service to reflect what it contends are higher costs than are currently recognized in rates?
- (14) **Interruptible Rates** – Should Xcel’s interruptible rates be reduced to reflect claimed transmission cost savings resulting from interruptibility?
- (15) **Windsor Rates** – Should Windsor (green pricing) rates be set based on marginal cost rather averaged cost?
- (16) **Contributions in Aid of Construction** – What are reasonable rates for contributions in aid of construction, the special charges assessed to new customers to whom the Company cannot extend service without incurring significant expense?
- (17) **Form of Payment for Contributions in Aid of Construction** – Should Xcel retain discretion to determine in individual cases whether Contributions in Aid of Construction are paid up-front, in installments, or in some other form?
- (18) **Financial Neutrality Factor** – Should the Commission establish a mechanism to partially compensate the Company for earnings opportunities lost due to its aggressive implementation of demand-side management, conservation, and energy efficiency measures?

III. Summary of Commission Action

The parties cited to record evidence to support and explain their disposition of every settled or stipulated issue, as required by earlier Commission orders. The Administrative Law Judge found their resolutions of all settled and otherwise resolved issues reasonable, in the public interest, and supported by substantial evidence; she recommended that the Commission accept and adopt those resolutions.

The Commission has examined the record, concurs with the ALJ on the settled and otherwise resolved issues, and accepts and adopts her recommendations on these issues.

The contested issues are treated individually below.

IV. The Treatment of Revenues from Flint Hills

A. Background and Issue

Flint Hills Resources (Flint Hills)¹ was Xcel's largest retail customer in its last rate case.² Accordingly, rates set then reflected Xcel's cost of capacity needed to generate, transmit and distribute electricity for Flint Hills, as well as the revenues expected to be received from Flint Hills.

In 1996, Flint Hills sought legislation that would allow it to build a cogeneration facility to serve its load and be exempted from personal property taxes. If Flint Hills had constructed the facility, Xcel would have faced a loss of generation and transmission revenues. The resulting legislation, Minn. Stat. § 216B.1621, authorizes the customer that proposes to build or acquire its own generation to negotiate a discount in exchange for delaying the construction of the generation.

An agreement was reached to defer construction of a facility, but Flint Hills and Xcel did not successfully negotiate a discount. As a result, Flint Hills arranged to purchase energy from a coalition of cooperatives. However, Xcel and Flint Hills reached an agreement under which Xcel would deliver the power, with Flint Hills paying Xcel the transmission and distribution rate.

Flint Hills informed Xcel in February of 2006 that it would return as a full requirements customer when its contract with Xcel to provide transmission and distribution expires on December 31, 2006. On January 1, 2007, Flint Hills will return to its status as Xcel's largest customer. Flint Hills is expected to account for about 3% of Xcel's retail energy sales in Minnesota.

The issue posed is whether rates should be adjusted effective January 1, 2007, because Flint Hills is expected to return as a full requirements customer.

B. Positions of the Parties

1. Xcel

In addressing this issue, Xcel posed two questions:

1. Is there a compelling need to reflect the change in revenue and costs associated with serving Flint Hills that does not occur until after the close of the projected test year?
2. If an out-of-test-year adjustment is appropriate, can it be fairly limited to the impact of Flint Hills or should it consider other known and measurable cost changes that will occur in 2007?

Xcel argued that it had met its burden in showing that the Flint Hills agreements were reasonable and in the best interest of the ratepayers. Xcel claimed that the Commission has previously rejected efforts to include in rates costs or revenue changes beyond a projected test-year.

¹ Flint Hills was formerly known as Koch Refining Company, L.P.

² Docket No. E-002/GR-92-1185.

Xcel argued that if the Commission chose to include a Flint Hills adjustment, past Commission policy would dictate that other known and measurable changes be likewise reflected in the 2007 test year.³

Finally, Xcel argued that Commission precedent from its 1992 rate case prevents the return of Flint Hills in 2007 rates.⁴ The Company argued that creating two revenue requirements in this proceeding, to reflect the return of Flint Hills as a full requirements customer, would be inconsistent with Commission policy.

2. The Department

The Department urged the Commission to include Flint Hills' 2007 incremental capacity revenues in the test year, arguing that failure to do so would result in unjust and unreasonable rates. The Department argued that the Commission must match costs and revenues so that each is based on the same assumptions. It urged the Commission to either eliminate the incremental capacity costs already included in the test year, or to also impute the associated revenues.

The Department emphasized that the 2006 test year forecast already includes all costs of serving Flint Hills as a full requirements customer in 2007. The Department referred to the integrated resource plan Xcel filed in 2004, which included a level of capacity that far exceeded the amount necessary to serve Flint Hills in 2007.

The Department further argued that Xcel's decision to not include Flint Hills revenue leaves "out of period" costs loaded into the test year, without recognizing revenues. To counter this, the Department suggested that the Commission either exclude the excess incremental capacity costs from test year expenses, or impute the associated 2007 revenues to match the already included capacity costs. The Department recommended imputing revenues related to service to Flint Hills in 2007 to balance the included capacity costs.

The Department relied on prior instances where the Commission has recognized known and measurable changes to achieve a just result. In its case before the ALJ, the Department referred to two prior Commission proceedings where the Commission approved known and measurable changes in order to achieve a representative test year.⁵

The Department also argued that Xcel knew at the time it filed its rate case that its contract to provide transmission and distribution services with Flint Hills was set to expire on December 31, 2006, the last day of its proposed test year. The Department argued that Xcel's exclusive control over the timing of

³ Xcel pointed to four other cost increases that it argued should be reflected in any rate adjustment beginning January 1, 2007.

⁴ In the Company's 1992 rate case, Manitoba Hydro demand costs began to be incurred during the test year. In that proceeding, however, the Commission rejected Xcel's proposal for a second test year revenue requirement that included an annualized level of costs for the Manitoba Hydro power purchase agreement.

⁵ Docket No. E-017/GR-86-380 (Otter Tail Power) and Docket No. E-015/GR-94-001 (Minnesota Power).

the rate case was a key reason that the Commission should make this out-of-test-year cost adjustment. The Department argued that rates effective January 1, 2007 forward should be adjusted to reflect a known and measurable change reducing the revenue requirement by approximately \$19 million. This number, according to testimony by Department witnesses, represents the difference between the incremental revenues and average cost of fuel and purchased energy.

The Department posited that incremental capacity revenues be imputed for purposes of setting final rates as follows:

1. For final rates effective prior to January 1, 2007, the revenue requirement should not reflect incremental revenues associated with Flint Hills as a full requirements customer.
2. For final rate effective on and after January 1, 2007, Flint Hills should be reflected in rates as a full retail customer in the test year.

Finally, the Department argued that recognizing Flint Hills' incremental capacity revenues prior to January 1, 2007 would be reasonable, in that the test year includes excess capacity costs sufficient to fully serve Flint Hills prior to January 1, 2007. Since the capacity revenues were not recovered by Xcel in interim rates, the Department agreed to not include the revenues in the rate case until such time as Flint Hills begins paying them to Xcel.

The Department's sales forecast recommendation for rates effective on and after January 1, 2007 increases the test-year electric sales by \$40,895,000 and the cost of fuel and purchased energy by \$21,859,000.

3. RUD-OAG

The RUD-OAG supported the Department's position and recommended that the Commission order the imputation of approximately \$19 million in incremental generation capacity revenues for Flint Hills.

4. Large Industrials

The Large Industrials supported the Department's position and disagreed with Xcel's proposition that the test year concept prohibits the Commission from taking into account a major change that is occurring immediately after the close of a test year. The Large Industrials argued that the Commission is clearly able to do more than mechanically apply test year calculations in order to achieve fair and reasonable rates. The Large Industrials urged the Commission to accept the Department's position and to make the appropriate adjustments to the revenue deficiency to recognize Flint Hills return to the customer base.

C. Recommendation of the Administrative Law Judge

The Administrative Law Judge found that there were compelling reasons to account for the return of Flint Hills as a full requirements customer as of January 1, 2007. The ALJ emphasized that the return of Flint Hills constitutes a known and measurable change that will take place "less than a millisecond" outside of the test year. Xcel selected the test year and controlled the timing of the filing of the rate case. The ALJ pointed to the fact that if the change is not accounted for, rates will fail to reflect significant annual revenues from Xcel's largest customer, although its energy costs will be distributed through the fuel adjustment clause.

The ALJ further found that under the unique circumstances presented, a net adjustment of \$16,637,966 to decrease Xcel's revenue requirement for the period January 1, 2007 forward is appropriate and necessary.⁶ The ALJ did not recommend any offset for other costs submitted by Xcel as known and measurable, finding that inclusion of the costs unrelated to Flint Hills would be inconsistent with the test-year concept.

D. Commission Action

The Commission concurs with the Administrative Law Judge that the facts in this case compel an adjustment to test year revenues to reflect the return of Flint Hills as a full-requirements customer. Failing to adjust for this known and measurable change would not result in just and reasonable rates.

1. Test Year Philosophy

In addressing the decision whether to supplement filed test year data that becomes available after the close of the test year, the Commission has articulated a test year philosophy and applied a balancing test.

The Commission has summarized the reasons for the test year as follows:

. . . Basing revenue requirements on financial data from a test year, a representative slice of the utility's normal operations, is intended to base rates on experience instead of conjecture. It is also intended to replace the fiscal discipline of the market place, which is absent for monopolies, with the fiscal discipline of prior determination of reasonable costs. Finally, it is intended to give utilities and ratepayers the assurance that their rates will not be changed retroactively. . . .⁷

The Commission has been reluctant to allow adjustments to filed test year data, as test years are imprecise instruments whose value depends in part on maintaining the same margin for error on both sides of the ledger.

. . . the test year method by which rates are set rests on the assumption that changes in the Company's financial status during the test year will be roughly symmetrical – some favoring the Company, others not. Not adjusting for either type of change maintains this symmetry and maintains the integrity of the test year process. Anomalies are likely to exist in and beyond the test year.

⁶ This is the number calculated by Xcel to reflect service at the A15 rate with the additional capacity for the summer of 2007.

⁷ *In the Matter of the Application of Northern States Power Company for Authority to Increase its Rates for Electric Service in the State of Minnesota*, Docket No. E0992/GR-89-865, Order Denying Petitions for Reconsideration and Denying Transitional Rate Increase (November 26, 1990).

In keeping with these general principles, the Commission has adjusted for changes in the past only when their certainty and magnitude would otherwise make the test year process unreliable. . . .⁸

2. Updating Test Year Data

When faced with a proposal to file updated test year data, the Commission examines each proposal on a case by case basis, balancing the value of the information against the difficulty of verifying and analyzing it within the time constraints of a general rate case. An example of such balancing was in Xcel's 1991 rate case, where the Commission admitted late-filed material on grounds that its value was significant and the time required for verification and analysis was minimal.

The Commission agrees with the Administrative Law Judge that the two adjustments proposed by the Company should be admitted into the record. . . Their inclusion will provide a more accurate picture of test year expenses, aiding the Commission in determining just and reasonable rates. . . . The goal of the rate case process is to arrive at just and reasonable rates. To do this, the Commission needs the most accurate and reliable information available. The Commission is therefore disinclined to exclude useful information on narrow technical grounds unless its inclusion raises problems of fairness or accuracy.⁹

3. Adjustment to Test Year Revenues Required

Every case is unique, and must be decided on its own set of facts. The Commission finds that the return of Flint Hills, one day beyond the test-year, compellingly justifies an adjustment to decrease Xcel's revenue requirement for the period January 1, 2007 forward for three reasons.

First, the return of Flint Hills as a full requirements customer is a "known and measurable" change that will occur *immediately* after the close of the test year, and the exclusion of which would make the test year process in this matter unreliable.

Second, Xcel chose the test year and controlled the filing of the rate case. If the return of Flint Hills is not accounted for, rates going forward will fail to reflect significant annual revenues from Xcel's largest customer, inappropriately raising rates for other customers.

Third, the Commission has in other rate cases recognized known and measurable changes when necessary to set just and reasonable rates.¹⁰ The Otter Tail Power rate case is akin to the situation

⁸ *In the Matter of the Petition of Minnesota Power & Light Company, d/b/a Minnesota Power, for Authority to Change its Schedule of Rates for Retail Electric Service in the State of Minnesota*, Docket No. E-015/GR-87-223, Order After Reconsideration and Rehearing (May 16, 1988).

⁹ *In the Matter of the Application of Northern States Power Company for Authority to Increase Its Rates for Electric Service in the State of Minnesota*, Order Affirming Decision of Administrative Law Judge, Docket No. E-002/GR-91-1 (June 26, 1991).

¹⁰ *See also*, Docket No. E-015/GR-94-001 (Minnesota Power).

here, where the Commission faced a scenario that caused it to set two different revenue requirements.¹¹

Otter Tail's projected 12-month test period ended June 30, 1987. In the rate case, the company proposed the use of federal income taxes based on the tax laws known at the time of the filing. After the rate case was filed, the Tax Reform Act of 1986 was passed,¹² reducing the maximum corporate federal income tax from 46% to 34%. The new legislation took effect on July 1, 1987, one day after the end of the test-period in the rate case. The Commission's Order in the rate case took the change in the law into account, in essence setting two revenue requirements, one before the new statute took effect, and a second to take into account the change in the law.

In this case, the Commission agrees with the ALJ that there are compelling reasons to account for the return of Flint Hills as a full requirements customer on January 1, 2007, the day following the close of the test-year. The Commission finds in this matter that not recognizing the return of Flint Hills, Xcel's largest customer, in base rates, clearly would make the test year unreliable.

Xcel's arguments that no adjustment to the 2006 test year period should be made are without merit. Xcel's principal argument, based on the Commission's rejection of Xcel's proposal for a second test year revenue requirement for the Manitoba Hydro power purchase agreement in its 1992 rate case, is unpersuasive. Every prospective out-of-test year expense is context-specific and fact-specific and must be carefully examined on its own merits.

Further, in reaching its decision, the Commission has subtracted expenses the Department wanted to exclude, but the ALJ permitted. The Department's figure of \$19 million was calculated based on the assumption that Flint Hills would take service under the A14 rate. Xcel argued that the A15 rate was appropriate, which yields a total increase of \$16,637,966, accounting for increased expenses. The Commission adopts this recommendation as appropriate.

Finally, the Commission will not include the additional test year adjustments requested by Xcel,¹³ unrelated to Flint Hills, in rates. Neither the timing nor the amount of these expected increases is nearly as certain as the timing and amount of the Flint Hills margins. Further, none of the four rise to the level of significance of the return of Xcel's largest customer. After conducting exhaustive evidentiary hearings in this case, the ALJ did not find that the other test year adjustments requested rise to the level of known and measurable changes; hence they will not be included in rates.

For all these reasons, the Commission accepts and adopts the ALJ's findings, recommendations and reasoning on this issue.

¹¹ Docket No. E-017/GR-86-380.

¹² Public Law 99-514.

¹³ Xcel requested adjustments for the selective catalytic reduction operating costs at the A.S. King plant, Nuclear Regulatory Commission fees, Nuclear Management Company costs, and bad debt expense.

V. FAS 106 Post-Retirements Benefits

A. Background

Xcel included \$8,967,000 as 2006 test year expenses for post-retirement benefits. The expense arises primarily from the provision of medical coverage for retirees. The only issue under dispute is whether rates should be based on the actuarially established 2006 costs or whether rates should be based on a five-year average of the historical costs.

B. Positions of the Parties

Xcel argued that the expense being accrued under the Financial Accounting Statement 106 (FAS 106) has steadily increased over the last six years due to increasing medical costs. Xcel argued that its actuarially determined amount should be allowed. Xcel claimed that the amount of the expense has increased over the past six years, with only 2004 experiencing a decrease due to a change in the law.¹⁴

Xcel explained that per capita claims cost has significantly exceeded the increase assumed in the actuarial calculation for each year over the years 2001 - 2005.

Xcel disputed the Department's use of a five year average, which resulted in an amount lower than the actual costs in any year since 2002. Xcel argued that there is no indication that medical costs will drop at any point in the foreseeable future.

Xcel argued that the Department provided no analysis to support its premise that the eventual shrinkage in the pool of retirees¹⁵ justifies setting the test year cost at pre-2003 levels. Xcel argued that there has been no shrinkage in the FAS 106 expense to date, and that expenses are not expected to shrink to the level set forth by the Department until 2013.

The Department recommended reducing test year FAS 106 costs by \$1,265,000, using a five-year average of historical costs. The Department did not dispute the accuracy or reasonableness of the claimed 2006 expenses; instead, the Department argued that Xcel's historical expense levels showed fluctuation; hence the Department posited that it is appropriate to use a leveled amount based on a five-year period instead of the actuarially determined amount.

In its exceptions to the ALJ recommendations, the Department amended its recommendation to utilize a four-year average. The Department maintained its disagreement over the use of the actuarial report, instead urging the Commission to use an average of actual historical costs.

The Department argued that the ALJ's report appeared to wrongly shift the burden of proof to the Department – to disprove Xcel's position. The Department argued that Xcel failed to provide detailed information on the actuarial assumptions utilized, in order to replicate the forecast.

¹⁴ The Medicare Prescription Drug Improvements Act was signed into law in 2003.

¹⁵ The pool of beneficiaries closed in 1999 when Xcel replaced post-retirement medical benefits with an adjustment to its pension program.

C. Recommendation of the Administrative Law Judge

The ALJ recommended Xcel's cost of \$8,967,000 as reasonable. The ALJ stated that over the years 2001 through 2005, the actual per capita claims cost has significantly exceeded the expected increase assumed in the FAS 106 actuarial calculation for each year, making the actuarially determined 2006 test year expense conservative compared to actual claims experience.

The ALJ calculated that the Department's five-year average cost was lower than the actual costs in any year except 2002. The ALJ observed that the Department did not provide a cost analysis to support its position that the pool's eventual shrinkage justifies setting the expense at the five-year historical cost average.

D. Commission Action

The Commission accepts and adopts the Administrative Law Judge's findings, recommendations, and reasoning on this matter, and sets the amount of \$8,967,000 as 2006 test year expenses for post-retirement benefits.

Xcel's proposed amount of \$8,967,000 was based on the calculations provided by its outside actuaries. The Department did not challenge the actuarial estimated 2006 costs.

While the Department is correct that the pool of beneficiaries will eventually begin to shrink, the actuarial forecast provided by Xcel demonstrates that the Department's proposed rate adjustment is not appropriate.

The actuarially established cost appears reasonably conservative and is not likely to result in the Company over-recovering its costs.

VI. Severe Storm/Tree Trimming Costs

A. Positions of the Parties

The Company proposed to establish a \$2 million annual "severe storm" reserve and to include this cost in the 2006 test year cost of service. Alternatively, Xcel proposed to increase the tree trimming (vegetation management) test year expense by \$2 million.

Xcel argued that the two proposals will improve electric service reliability while allowing the Company a reasonable means by which to manage its costs. Xcel proposed to:

1. Establish a reserve to provide a pool of funds available for the Company to fund additional restoration operations and management costs in the event of a severe storm;
2. Fund additional tree trimming by increasing expenditures above currently budgeted levels.

The Department opposed the \$2 million increase proposed, for either "severe storms" or vegetation management. Disallowing the additional \$2 million would reduce test year expenses by \$2 million.

The Department argued against the severe storm proposal based on several factors. The Department expressed concern about the complications involved in determining whether costs for storms are considered regular storm costs. The Department also argued that Xcel did not support its need for any additional reserve for severe storms. The Department argued that even if the cost of responding to severe storms was included in a rate case, there is nothing in the record to establish that \$2 million is the correct amount. Finally, it appears that Xcel already builds storm costs into rates, and a reserve would allow double-recovery of these costs from existing base rates and in the severe storm reserve.

The Department opposed the expenditure of the \$2 million on vegetation management (tree-trimming), because while it strongly supports adequate tree trimming, it argued that Xcel already has built sufficient tree-trimming costs of \$20.9 million into its test year costs in this proceeding.

The RUD-OAG supported the Department's position and recommended that the Commission reject Xcel's proposed \$2 million cost.

B. Recommendation of the Administrative Law Judge

The ALJ found that the record supported Xcel's contention that it needs more funds to address severe storm damage, either through the severe storm reserve or through an increase in its tree-trimming budget. The ALJ found that despite budget increases, there are still a significant number of service outages that could be reduced through additional tree trimming. Thus, the ALJ recommended that the Commission adopt Xcel's alternative proposal, to increase the tree-trimming budget by \$2 million.

C. Commission Action

The Commission agrees with the Department and the RUD-OAG that Xcel already has adequate funds dedicated to vegetation management, or tree trimming; hence it accepts the Department and the RUD-OAG's recommendation to disallow the requested \$2 million.

Xcel initially requested a \$2 million increase in test year expenses to establish a severe storm reserve, something which it has not explicitly budgeted for in the past but instead has covered through its operations and management budget. Xcel subsequently set forth an alternative purpose of vegetation management, or tree trimming, for the \$2 million.

The Commission finds that Xcel's request for the \$2 million, on an either/or basis, tends to cast some doubt on the legitimacy of the underlying need for these additional funds. The Commission is not convinced that Xcel's test year expense budget is insufficient to cover either severe storms or tree trimming without the additional funds.

With respect to Xcel's alternative proposal to spend the \$2 million as additional monies to support its vegetation management program, the Commission remains strongly supportive of adequate tree trimming. However, the Commission is confident that Xcel already has built sufficient tree trimming costs into its base rates,¹⁶ particularly given the importance of these issues in recent years. The

¹⁶ Xcel's vegetation management budget has increased from approximately \$15 million in 1998 to \$20.9 million for the 2006 test year, an increase of nearing 40%, or a 4.9% increase per year. The \$2 million requested is over and above that amount, for a total of \$22.9 million.

Commission encourages the Company's recent efforts on this important issue and anticipates that Xcel's recent undertaking of a "circuit based" approach to tree trimming, in compliance with its Service Quality Order,¹⁷ will further reduce the number of outages due to insufficient tree trimming.

VII. Incentive Compensation

A. Background and Issues

Xcel's incentive compensation program is intended to allow Xcel to attract, retain and motivate employees to achieve its performance objectives. Target annual incentives as a percentage of base salary are set for each eligible employee. Incentives are awarded based on the employee's individual performance and the Company's overall performance.

Xcel retains the discretion to withhold earned incentive compensation based on its financial performance.

Because Xcel retains the discretion not to pay out incentive compensation if it performs poorly, the Commission required Xcel to record all earned but unpaid incentive compensation in rates for future return to ratepayers through a refund mechanism.¹⁸

The issues here focus on:

1. Whether the test year expense amount should be set at test year target amounts or 2006 budgeted expected amounts; and
2. Whether the test year expense should be allowed at 15% or 25% of an individual employee's base salary.

B. Positions of the Parties

Xcel proposed that its budgeted level of annual incentive compensation, 27% of target levels, be adjusted to 100% of target levels, subject to a cap of 25% of the individual employee's base compensation and the refund mechanism. This amounts to approximately \$9,354,666.

Xcel's incentive compensation levels are set according to competitive levels based on market data collected by its compensation consultant, Towers Perrin, in 2005. The compensation study found Xcel's incentive targets are well-aligned with those of other utilities, its total cash compensation levels, including the incentive plan at full target levels, are comparable to those of other utilities but are about 6% below market rates for similar-sized utilities. With the proposed cap of 25% of base salary, Xcel's total cash compensation would be 3% below market rate for all utilities and 9% below the market rate for comparable utilities.

¹⁷ *In the Matter of Northern States Power Company d/b/a Xcel Energy's Annual Safety, Reliability and Service Quality Report Under Minnesota Rules Chapter 7826*, Docket No. E-002/M-05-551. Order Accepting Annual Reports, Setting Reliability Standards, and Setting Filing Requirements (April 7, 2006).

¹⁸ See Xcel 1992 Rate Case, Docket No. E-002/GR-92-1185, Order After Reconsideration at 7-8 (January 14, 1994)

Xcel explained that the incentive plan is designed to, and attains its goals of motivating employee performance to achieve overall customer satisfaction, reliability, environmental goals and cost effective operations. The Company urged the Commission to support its plan because:

1. Increasing base compensation to offset a limited incentive plan would lead to higher costs due to higher salary costs and the costs of benefits; and
2. The refund mechanism protects customers from any risk of over-collection.

The Company argued that the Department's recommendations should not be followed because:

1. Basing the incentive level solely on the 2006 budgeted payout level is not appropriate because it may not be representative of future payout levels once the effects of the current rate case are taken into account; and
2. The refund mechanism was adopted to address the risk of over-collection, and the cost of implementing the refund and delays between collection and refund are offset by benefits and interest.

In its exceptions to the ALJ recommendations, the Company argued that the Commission should adopt a policy to use the refund mechanism as a means to protect ratepayers from overpayment, and include the full amount of incentive compensation at target levels, subject to the 25% recommended by the ALJ.

Xcel argued that if the Commission were to accept the ALJ's recommendation, the calculation utilized requires correction, resulting in a test year annual incentive of \$5,425,126.¹⁹

The Department proposed to decrease Xcel's recommendation of \$9,354,666 by one of two methods:

1. Use the test year budget to set incentive levels, subject to a cap of 15% of base salary, resulting in a reduction of \$6,952,345; or
2. Use an average of 2002 actual, 2004 actual, and 2006 budgeted amounts, net of individual incentive compensation in excess of 15% of base pay,²⁰ resulting in a reduction of \$5,854,000.

The Department argued that its proposed limitation on the cap on individuals' salaries to 15% was consistent with the Commission's decision in the NSP 1992 rate case as well as its recommendations in two recent rate cases.²¹

¹⁹ Xcel provided revised financial schedules reflecting revised revenue requirements and rate design decisions recommended by the ALJ on July 17, 2006.

²⁰ The Department did not include data for 2003 and 2005 because Xcel did not have data necessary to determine the amount of incentive in excess of 15% of base salary for those years.

²¹ Docket No. G-004/GR-04-1487(Great Plains); Docket No. E-001/GR-03-767 (Interstate Power & Light).

In its exceptions to the ALJ recommendations, the Department agreed that the ALJ's calculation was reasonable, but argued that its recommendation to set the test year expense at \$2,401,321 using a 15% cap was also reasonable. The Department argued that the 25% cap recommended by Xcel and the ALJ is not based on Commission precedent.

C. Recommendations of the Administrative Law Judge

The ALJ found neither the proposal of Xcel or the Department entirely appropriate in terms of establishing a representative test year expense. The ALJ found that Xcel's amount is greater than it has actually paid since its problems with NRG in 2002. While subject to the refund mechanism, the test year amount still needs to be set at a realistic number not guaranteed to over-recover the expense.

The ALJ found the Department's proposal, limiting incentive payments to a total of 15% of base pay, would set the test year expense at an amount substantially lower than Xcel actually paid in any year from 2000-2005.

The ALJ recommended reducing the test year incentive compensation by \$4,218,000, including a refund provision for unpaid incentive compensation, to reflect the actual payouts for 2002-2005 and a 25% cap on individual base pay.

D. Commission Action

The Commission concurs with, accepts, and adopts the ALJ's recommendation on this issue, which was to cap individual incentive payments at 25% of an employee's base salary; to base total, company-wide incentive compensation on amounts actually paid out between 2002 and 2005; and to continue the tracking and refund mechanism established in the Company's 1992 rate case.²²

While there is market evidence to suggest that higher overall incentive compensation amounts might be defensible, the amounts Xcel has actually paid have consistently fallen short of the amounts the Commission has authorized. The Commission concurs with the ALJ that this actual payment history merits heavy reliance.

While the Company is entitled to recover its reasonable cost of service, its consistent history of over-recovering incentive compensation costs cuts against granting the substantial test year increase it seeks. Although these amounts are tracked and refunded to ratepayers when not paid, refunds are no substitute for properly set rates, especially for low-income ratepayers.

The Commission will therefore accept and adopt the ALJ's recommended reduction to this test year cost, also accepting the Company's ministerial correction to her number, resulting in reduced test year costs of \$3,929,000.

²² 1992 Electric Rate Case, Docket No. E-002/GR-92-1185, Order After Reconsideration (January 14, 1994).

VIII. Amortization of Nuclear Waste Storage Investment Costs

A. Background

The Minnesota Legislature has authorized Xcel to store nuclear waste at Prairie Island, subject to a number of conditions, including that Xcel seek out-of-state storage for spent fuel. To comply with the legislative mandate, Xcel participated in the development of a private independent spent fuel storage installation (ISFSI). In 1997, Xcel and seven other utilities formed a limited liability company to obtain authorization to site and construct a private ISFSI within the Goshute Indian tribal land in Utah. Construction of the project is on an indefinite hold, due to pending legal and legislative challenges.

Xcel has invested \$23,302,299 in the facility. Xcel included \$5,789,099 as test year expense, representing a three year amortization of the invested amount, with no rate base treatment.

B. Positions of the Parties

With the construction of the facility on indefinite hold, Xcel proposed that the start-up investment costs be recovered without placing the investment into rate base. The Department agreed that recovery of the investment was reasonable and that the investment should be amortized. The only issue under dispute about the investment is the length of the amortization period.

The Department recommended the investment be recovered over ten years, because 1) the investments were made over a ten-year period; 2) the investments are not being written off, and it is uncertain whether the facility will become necessary; and 3) the costs of the facility should be paid by the customers who benefit from low nuclear power costs. The Department further suggested if Xcel files an electric rate case before the deferred amount is fully amortized, any unrecovered balance could be recovered in future rate cases. The Department justified the ten-year period as reasonable, arguing that the nuclear facilities may be re-licensed and the life of the facility extended.

In response, Xcel proposed a six-year amortization period. Xcel argued that its shareholders will receive no return on this investment, as the Company would accept the six-year amortization period without inclusion of the unamortized amount in rate base. Xcel further argued that the fact that the investment was made over a ten-year period justifies accelerating recovery, not delaying it.

C. Recommendation of the Administrative Law Judge

The ALJ concluded that the investment in the ISFSI was reasonable in light of the legislative directive to develop an out-of-state spent fuel storage location and that it is reasonable to amortize the recovery of the investment without including it in rate base. Further, the ALJ found that a six-year amortization period was reasonable due to the substantial number of years Xcel has already waited to recover its investment with no return. The ALJ found that there was no need to presently determine whether to impose a sunset on cost recovery once the amortization period ends, because it is reasonable to anticipate another rate case before the amortization period concludes.

D. Commission Action

At oral argument, both parties indicated agreement with the ALJ's recommendation. The Commission will, therefore, accept and adopt the recommendation and findings of the ALJ on this issue, and set the amortization period at six year, reducing the test year cost by \$2,903,000. The Commission will defer the question of the sunset provision until Xcel's next rate case.

IX. Time-of-Use Pilot Project Expense

A. Background

In 2001, the Commission initiated an investigation into developing a Time-of-Use (TOU) program for Xcel's residential customers.²³ During that proceeding, the Commission ordered Xcel to design TOU rates, which would charge consumers different amounts for electricity consumed at different times of the day.

In a report filed on April 9, 2002, Xcel proposed three scenarios for initiating TOU rates. Based in large part on the experience reported in a similar program in the state of Washington, which showed that residential customers paid higher electric bills than they would have paid without the program, the Commission terminated the pilot project.

Xcel subsequently petitioned the Commission, seeking approval of deferred accounting treatment so that these expenses could be recovered in the next rate case. Because Xcel had incurred these costs at the Commission's direction and because these costs directly benefitted ratepayers, the Commission concluded the costs were reasonable, and expressly authorized deferral of these expenses. The Commission also accepted the Department's recommendation that the appropriate amortization period should be set in Xcel's next rate case.

B. Positions of the Parties

Xcel argued that the Commission previously determined that the TOU program provided a public benefit and that the Company should be entitled to recover its costs in responding to the Commission's direction.²⁴ Xcel sought recovery of TOU expenses using a three-year amortization period. Xcel accepted the Department recommendation to use of a four-year amortization period, and requested recovery of \$2,469,247 in deferred TOU program costs.

The RUD-OAG opposed the TOU program. The RUD-OAG argued that because the Commission terminated the TOU program, there was no ratepayer benefit; hence there was no basis on which to allow Xcel to recover its costs. The RUD-OAG argued that Xcel cannot recover its start-up costs associated with the project because those costs were not "used and useful in service to the public." The RUD-OAG argued that the Commission has considered and denied recovery of similar expenses in other rate cases.

²³ Docket No. E-002/CI-01-1024.

²⁴ *In the Matter of Northern States Power Company d/b/a Xcel Energy's Petition for Approval of Deferred Accounting for Costs Incurred for the Web Tool and Time-of-Use Pilot Project*, Docket No. E-002/M-03-1462, Order Approving Deferred Accounting (February 25, 2005).

The RUD-OAG further stated that the Commission should deny recovery of approximately \$1.6 million in costs associated with Deloitte Consulting. The RUD-OAG contended that these costs were improperly incurred, because at the same time Xcel recruited the company to manage the TOU project, Xcel was also using Deloitte as its auditor. The RUD-OAG argued that the dual role violated the rules of the Securities and Exchange Commission, which prohibit auditors from performing management activities for the companies they audit.

C. Recommendation of the Administrative Law Judge

The ALJ recommended that Xcel be permitted to recover its costs in this case using the four-year amortization period recommended by the Department. The ALJ relied on the fact that in its TOU Order, the Commission expressly found that Xcel's costs, including the Deloitte Consulting costs, were reasonable, and authorized Xcel to recover them in its next rate case.

D. Commission Action

The Commission concurs with the ALJ that Xcel should be permitted to recover its costs for the TOU program, using the four-year amortization period. The Commission has already considered this issue, and determined Xcel's costs to be reasonable.

In conclusion, the Commission finds that the \$2,469,247 in costs for developing the TOU pilot project as directed by the Commission arose from a unique set of circumstances and have been shown to be reasonable. Xcel should not be penalized financially for complying with the Commission's directive to develop a program that had the potential to positively impact residential customers' consumption of electricity patterns. Xcel will be allowed deferred accounting for these costs.²⁵

X. Rate Recovery of Income Tax Liability

I. The Issue

In its initial filing, Xcel's income tax liability for the test year is \$88.171 million in federal income taxes and \$27.37 million in state income taxes. These figures are not contested; ratepayer Myer Shark and the RUD-OAG, however, argued that Xcel should not be permitted to recover its tax expense in rates because Xcel's tax liability was ultimately offset by tax deductions for an approximately \$3 billion loss sustained by an unregulated affiliate. That loss was due to an investment by Xcel's Wholesale Group in NRG Resources, Inc., an independent power producer, which went bankrupt.

Since all Xcel affiliates join in filing a consolidated tax return, as permitted by this Commission, the Internal Revenue Service, and the Financial Accounting Standards Board,²⁶ Xcel's tax liability was not paid to either state or federal tax authorities, but instead became subject to an allocation agreement between the parent company and its subsidiaries.

²⁵ Docket No. E-002/M-03-1462.

²⁶ Financial Accounting Standard 109.

B. Positions of the Parties

Ratepayer Myer Shark and the RUD-OAG characterized Xcel's tax liability as phantom taxes and argued that there should be no rate recovery of a tax liability that was not ultimately paid to state or federal tax authorities. In the alternative, they argued that ratepayers should at least share in the tax deduction by granting only partial rate recovery of the tax liability.

C. Recommendation of the Administrative Law Judge

The Administrative Law Judge found that the entire tax liability should be recovered in rates, pointing out, among other things, that the tax liability was real; the affiliated companies were legally entitled to file a consolidated return; the ratepayers had borne none of the costs giving rise to the tax deduction; the Commission had long been unreservedly committed to cost allocation principles requiring strict separation of regulated and unregulated costs and revenues; the tax treatment proposed for the test year would increase rate base – and rates – if applied to deferred taxes, as consistency required; and making the proposed adjustment would necessarily require numerous other adjustments, for which the record contained inadequate factual support.

D. Commission Action

The Commission concurs with the Administrative Law Judge on this issue and accepts and adopts her findings, conclusions, and recommendations. Her analysis is thorough and grounded in an exhaustive evidentiary record. The Commission will not repeat that analysis here, but will highlight the importance of its existing cost- and benefit-allocation principles and the dangers inherent in result-driven decision-making.

While the challenge to rate recovery of the income tax expense may have superficial appeal, disallowing rate recovery in this case would be both result-driven and inconsistent with the cost- and benefit-allocation principles the Commission has applied to all Minnesota gas and electric utilities over the past twelve years.²⁷

These allocation principles, modeled after the cost separations procedures of the Federal Communications Commission, were developed and adopted after a lengthy, industry-wide proceeding to determine how to protect ratepayers from the potentially adverse consequences of utility diversification into unregulated enterprises. They have proven clear and effective and have become an essential regulatory tool.

The Commission has consistently applied these principles over the past twelve years, not just to keep utilities from subsidizing unregulated affiliates, but to fairly allocate the joint and common costs of multi-jurisdictional utilities. They are applied on a frequent and recurring basis; the Commission has

²⁷ *In the Matter of an Investigation into the Competitive Impact of Appliance Sales and Service Practices of Minnesota Gas and Electric Utilities*, Docket No. G,E-999/CI-90-1008, Order Setting Filing Requirements (September 28, 1994).

issued two orders applying them in the past six months.²⁸ Further, the Commission has consistently applied the “stand-alone” tax methodology.

They were also the starting point and the foundation for the structural separation requirements imposed in the case the Commission opened to protect Minnesota ratepayers from any adverse consequences of the NRG investment, which produced this tax deduction.²⁹ These allocation principles allocate the challenged tax liability to Xcel, allocate the costs of the failed NRG investment to the unregulated affiliate, and prohibit any commingling or reciprocity between the two obligations.

Further, these principles also permit utilities to file consolidated tax returns, as *all* Minnesota utilities now do.³⁰ (In fact, Xcel would now need special permission from the Internal Revenue Service to do otherwise.³¹)

Unwinding these cost-allocation principles to reach a specific result in this case would carry grave risks. Not only would it call into question the Commission’s evenhandedness, but it would open every future allocation decision to endless argument about ever-shifting, difficult-to-gauge equities. And worse, it would arguably require the Commission to reopen the 1994 industry-wide, cost-allocation proceeding and set new cost-allocation principles.

As the Commission found when it adopted its current allocation procedures, it is impossible to establish principled, self-executing, *one-sided*, allocation mechanisms. Any sharing of benefits is inevitably accompanied by the sharing of risks, which is why the Commission adopted and continues to enforce strict “stand-alone” allocation principles.

It is far more important to protect ratepayers from loss than to give them opportunities for windfalls. While ratepayers will not be harmed by missing a chance for a tax break they had nothing to do with creating, they would be harmed by paying higher rates to cover losses from unregulated investments they had nothing to do with making.

It would be imprudent to throw off the protections that have shielded ratepayers from the adverse impacts of twelve turbulent years of unregulated utility investments, in order to claim a tax refund that might not exist, had those protections not spared ratepayers the consequences of a catastrophic unregulated investment. And any reevaluation those protections might merit should take place only in another lengthy, carefully considered, industry-wide proceeding.

²⁸ *In the Matter of Otter Tail Power Company’s Report on a Call to its Ethics Hotline*, Docket No. E-017/M-04-1751, Order Requiring Further Filings (March 10, 2006); *In the Matter of the Sale of Aquila, Inc.’s Minnesota Assets to Minnesota Energy Resources Corporation*, Docket No. G-007,011/M-05-1676, Order Approving Sale Subject to Conditions (June 1, 2006).

²⁹ *In the Matter of an Inquiry Into Possible Effects of Financial Difficulties at NRG and Xcel on NSP and its Customers and Potential Mitigation Measures*, Docket No. E,G-002/CI-02-1346, Order Requiring Additional Information and Audit (October 22, 2002).

³⁰ Ex. 29, Duevel Direct, at 11, 14; Evidentiary Hearing, Vol. 8 at 35.

³¹ Evidentiary Hearing, Vol. 2 at 95.

For all these reasons, in addition to all the reasons set forth by the Administrative Law Judge, the Commission concurs in, accepts, and adopts her findings, conclusions, and recommendations on this issue.

XI. Capital Structure, Return on Equity, Overall Rate of Return

A. Capital Structure

Xcel's proposed capital structure – its proposed mix of long-term debt, short-term debt, and common equity – was not opposed by any party and is set forth below.

Component	Ratio
Long-Term Debt	45.57%
Short-Term Debt	2.76%
Common Equity	51.67%
Total	100.000%

The Administrative Law Judge found that the proposed capital structure was just and reasonable and recommended its approval. The Commission accepts and adopts the ALJ's findings and recommendation on this issue and approves the Company's proposed capital structure.

B. Cost of Debt

1. Positions of the Parties

The Company set its test-year cost of long-term debt at 7.08% and its test-year cost of short-term debt at 4.71%, providing extensive documentation and analysis.

The RUD-OAG expressed concern that the cost of debt might be inflated, arguing that a downgrade in the Company's credit rating, reflected in the record, might have been caused by its holding company's costly, failed NRG investment and might have increased its borrowing costs. (As discussed in the preceding section, both the Company and the holding company are obligated to protect ratepayers from all the consequences of that investment.) The RUD-OAG's concerns were general. The Division did not conduct an independent analysis of the cost of debt and did not advocate any specific adjustment to the cost of debt proposed by the Company.

The Department conducted an analysis of what the Company's cost of debt would have been without the credit rating downgrade, comparing Xcel's debt costs with those of comparable utilities with higher credit ratings. From these comparisons the Department concluded that the NRG investment and the resulting credit rating downgrade had not affected the Company's cost of debt.

The other intervenor who addressed this issue, Excelsior Energy, Inc., also concluded that the NRG investment had not affected the Company's cost of debt.

2. The Administrative Law Judge's Findings and Recommendation

The Administrative Law Judge recommended approving the Company's proposed cost of long- and short-term debt, rejecting as unsubstantiated RUD-OAG's claim that the NRG investment had increased the Company's borrowing costs.

3. Commission Action

The Commission concurs with the ALJ that, while the drop in the Company's credit rating merited careful examination – both because of its possible link with the NRG investment and because of its potential effect on borrowing costs – that examination demonstrates that Xcel has properly calculated test-year debt costs and that those costs do not reflect NRG-related increases. As the Department's analysis shows, the Company's test-year cost of debt is lower than that of many comparable utilities whose cost of debt is not even arguably affected by unregulated losses or other potentially compromising factors.

Although the credit rating downgrade probably did result from the NRG losses, the credit rating did not prove to be a determinative factor in the Company's cost of debt. Debt costs are the product of a host of factors besides credit ratings, including the terms and maturity dates of previously issued debt; revenue history and prospects; perceived degree of business, financial, and investment risk; and general economic conditions.

The Company took aggressive steps to try to prevent its credit rating downgrade from increasing its borrowing costs, including issuing a series of 40-year notes, using secured senior debt in place of unsecured debt, and using intermediate-term secured debt. And ultimately, for complex reasons that include this careful management of its financing initiatives, the Company was able to keep its credit rating downgrade – and the NRG losses that caused it – from increasing its borrowing costs.

For all these reasons, the Commission accepts and adopts the ALJ's findings and recommendation on this issue and approves the Company's proposed cost of debt.

C. Cost of Equity

1. Positions of the Parties

The Company and the Department both conducted comprehensive analyses of the cost of equity, using both the Discounted Cash Flow (DCF) analysis, on which the Commission has historically placed its heaviest reliance, and the Capital Asset Pricing Model (CAPM), which the Commission has historically used as a secondary, corroborating resource. Both parties added a 25-basis-point flotation adjustment to reflect the transaction costs of previous securities issuances.

The Company recommended a return on equity of 11%. The Department initially recommended a 10.54% return, but increased its recommendation to 10.64% mid-proceeding to take into account more recent economic data. Both of these recommended returns were based on a range of reasonable returns calculated for a group of comparable companies using the DCF method; the difference was mainly due to the Department's choice of a return at the mid-point of the range and the Company's choice of a return half-way between the mid-point and the beginning of the high end of the range. The Company also relied more heavily on the CAPM analysis than the Department.

The Company defended its choice of a return above the midpoint mainly on the basis of rising interest rates, its need for massive capital investments over the next five years, and the likelihood that the rates set in this case will still be in effect as these changes occur. The Department defended its choice of the midpoint mainly on the basis of the DCF method's robustness, its adequacy in accounting for virtually all investor needs and expectations, and the absence of any factor rare or unique enough to justify deviating from DCF results.

The Chamber of Commerce supported the Department's recommendation on the cost of equity.

The RUD-OAG did not support any particular return on equity but instead asked the Commission to consider reevaluating its approach and to begin basing returns on equity on the returns actually reported by comparable utilities. The Division stated that nation-wide, these returns were generally between 5% and 7% in 2004.

2. The Administrative Law Judge's Findings and Recommendation

The Administrative Law Judge conducted a thorough examination of the returns on equity proposed by the two parties who proffered them and determined that the Department's 10.64% return was well-grounded, transparent, reasonable, and supported by substantial evidence in the record. She found that the Company had failed to prove that its proposal to set the return on equity above the DCF midpoint was reasonable. She recommended setting the return on equity at the 10.64% recommended by the Department.

3. Commission Action

The ALJ's examination of this issue is carefully considered, closely reasoned, and based on an exhaustive evidentiary record. The Commission will accept and adopt her findings, recommendations, and reasoning in all respects but one – her treatment of the flotation adjustment.

Both the Company and the Department included in their return on equity a 25-basis point flotation adjustment, with little reasoning and little substantive support. The ALJ accepted it without discussion. The Commission sees serious potential for over-earning in granting a flotation adjustment as a matter of course. As the Commission explained the last time it examined this issue, flotation adjustments are generally granted only when stock issuances are anticipated:

The Commission has as a general practice rejected flotation adjustments in the absence of tangible evidence on actual securities issuances and their costs. In the 1991 Midwest Gas rate case, for example, both the Commission and the Administrative Law Judge rejected the Department's inclusion of flotation costs in return on equity because there was no factual demonstration that such costs would be incurred:

The other reason the Commission has not adopted Dr. Amit's testimony is his inclusion of a flotation cost adjustment for issuance of stock. In this case, as noted by the ALJ, Midwest Gas has failed to affirmatively establish facts that support a flotation cost adjustment.

Similarly, in the 1995 Minnegasco rate case, the Commission concurred with the Administrative Law Judge in denying a proposed flotation adjustment based on an insufficient factual showing:

Finally, the Commission rejects the Company's recommendation to add a flotation cost adjustment of 0.22 percent to the Department's required return on equity estimate. The Commission finds that the Company failed to demonstrate that a flotation cost was necessary and did not calculate a specific flotation cost adjustment for its own recommendation. In addition, the record did not contain evidence with respect to actual or projected issuance costs incurred by the Company.

Here, too, the record is devoid of any factual basis for granting a flotation adjustment, and it will be denied.

In the Matter of a Petition by Interstate Power and Light Company for Authority to Increase Electric Rates in Minnesota, Docket No. E-001/GR-03-767, FINDINGS OF FACT, CONCLUSIONS OF LAW, AND ORDER; ORDER MODIFYING SETTLEMENT (April 5, 2004), footnotes omitted.

In this case, the absence of affirmative, record evidence that Xcel plans to issue stock during the test year clearly cuts in favor of denying the entire 25-basis-point adjustment. At the same time, there is no affirmative, record evidence that the Company will *not* issue stock during that time, the parties did not address the issue, and the record contains many references to plans for an aggressive capital improvement program.

The Commission has no intention of hindering Company efforts to raise capital for this program, parts of which are critical to maintaining system reliability and to implementing state policies promoting the development of renewable generation technologies. The Commission will therefore reduce the 25-point flotation adjustment agreed to by the parties to 15 basis points, the same flotation adjustment permitted in the Company's last rate case, to ensure that potential transaction costs do not inhibit this important capital improvement initiative.

Finally, it is important for regulators to remain open to innovative regulatory concepts, but the RUD-OAG's suggestion that the Commission set the cost of equity in this case based on reported returns on equity is not supported by sufficient factual, legal, or policy analysis, or by sufficient record evidence, to merit detailed consideration in this proceeding.

D. Overall Rate of Return

The Commission's decisions on capital structure, cost of debt, and cost of equity result in an overall rate of return of 8.81%, as set forth below.

	Ratio	Cost Rate	Weighted Cost of Capital
Long Term Debt	45.57%	7.08%	3.23%
Short-Term Debt	2.76%	4.71 %	0.13%
Common Equity	51.67%	10.54%	5.45%
Total	100.000%		8.81%

XII. Class Cost of Service Study

While the preceding issues largely pertain to quantifying Xcel’s costs, the next issues will address how Xcel should set its rates to secure adequate revenues to cover those costs and earn a reasonable return on investment. This process of “rate design” requires the Commission to exercise policy judgment because there are many ways to set rates to enable a utility to recover appropriate revenues.

The Commission considers many factors in setting rates, including the cost of providing service. The cost of serving one customer will differ from the cost of serving another. But because similar types of customers impose similar types of costs on a utility, utilities find it useful to group customers into classes for purpose of analysis. Utilities learn about how the cost of serving one class of customer differs from another by conducting an embedded “class cost of service study” (CCOSS).³²

For purposes of the CCOSS, Xcel has divided its customers into categories such as Residential, Lighting, Commercial & Industrial C & I Non-Demand, and C & I Demand. (“Demand” customers pay a fixed monthly “demand charge” reflecting the cost of facilities used to provide them service, plus an “energy charge” in proportion to the amount of electric energy used; “non-demand” customers – including residential and smaller commercial customers – have the cost of providing plant and energy combined into a single charge for electricity.)

Parties raised a number of issues related to Xcel’s CCOSS but only three remain unresolved. One issue pertains to the extent to which Xcel considers how to allocate energy costs to each customer class. And two issues pertain to the type of analyses Xcel should make available to parties in the future.

A. Allocations Based on Time of Electricity Usage

1. Background and Issue

The Residential and C & I Non-Demand customer classes consume a larger percentage of their total energy consumption during periods of high (or “peak”) demand than do the other classes. Typically electricity costs more to generate or acquire during periods of peak demand than during other periods.

³² Minn. Rules pt. 7825.4300, subp. C; see also *In the Matter of the Application of Northern States Power Company for Authority to Increase its Rates of Electric Service in the State of Minnesota*, Docket No. E-002/GR-92-1185, FINDINGS OF FACT, CONCLUSIONS OF LAW, AND ORDER (September 29, 2003) (requiring marginal cost of service study for this rate case).

Xcel incorporated these facts into prior cost studies through the use of its “E20 allocator.” Specifically, Xcel calculated the average cost of electricity on-peak and off-peak, and allocated costs to each customer class in proportion to the amount of on-peak and off-peak electricity the class demanded.

In its current cost study, however, Xcel has generated a new allocator. Rather than simply distinguishing between on-peak and off-peak costs and consumption rates, Xcel now collects and analyzes data regarding cost and consumption for all 8760 hours of the year. With this new allocator, Xcel claims that it can more precisely identify and allocate the costs of serving each customer class.

The effect of using the E8760 allocator instead of the E20 allocator is to allocate a larger share of Xcel’s costs to residential and smaller commercial customers, and a smaller share to other customers.

2. Position of the Parties

The Department and Xcel supported the use of the new E8760 allocator, but RUD-OAG raised two objections.

First, RUD-OAG argued that the calculation of the E8760 allocator is so complex that it is essentially unreviewable. According to RUD-OAG, using this allocator requires a sacrifice of regulatory transparency that outweighs any benefits provided by the allocator’s allegedly greater precision.

Second, RUD-OAG argued that the new allocator effectively imposes mandatory time-of-use (TOU) rates. The Commission previously suspended an Xcel proposal to impose such rates.³³

3. Recommendation of the Administrative Law Judge

The ALJ recommended using the new E8760 allocator instead of the E20 allocator for purposes of conducting a CCOSS. According to the ALJ, the record supports the conclusion that the E8760 allocator produces a more accurate calculation of the cost of providing service to each customer class.

The ALJ was not persuaded that using the E8760 allocator would represent a new policy imposing mandatory TOU rates on customers. First, the ALJ notes that the resolution of this issue will not set Xcel’s rates; it will merely influence the CCOSS that the Commission will consider, among other factors, in setting rates. All parties retain the discretion to argue that rates should not reflect costs. Moreover, the ALJ notes that the use of an allocator is not new. The Commission approved the use of a comparable allocator during Xcel’s prior rate case. The E8760 allocator merely represents a refinement of Commission practice, not a new practice.

4. Commission Action

The ALJ correctly observed that the choice of allocators does not, by itself, set rates; it merely establishes a tool for measuring costs. The Commission prefers to make this tool as accurate as the record will support. The Commission finds that the 8760 allocator produces a more accurate calculation of class costs than the E20 allocator. Consequently the Commission concurs with the ALJ that Xcel should use the E8760 allocator instead of the E20 allocator in its CCOSS.

³³ See *supra*, Docket No. E-002/CI-02-1024, ORDER DECLINING TO PROCEED WITH PILOT PROJECT (June 23, 2003).

RUD-OAG accurately notes that the Commission previously declined to authorize Xcel to impose mandatory TOU rates on customers. In the TOU case, the Commission canceled a pilot project when it concluded that the project's costs would not be worth its benefits.³⁴ The Commission's reasoning in that matter has no relevance to this case.

Moreover, the Commission simply observes that the rates resulting from this case will not be mandatory TOU rates – that is, the resulting rates will apply uniformly regardless of when the customer uses the electricity. However, Xcel does offer some TOU rate options for customers who choose them.

Finally, given that the Department was able to review the E8760 allocator and finds it reasonable, the Commission is not persuaded that the E8760 allocator's complexity outweighs its usefulness. The allocator will be approved.

B. Break-Even Analysis

1. Background and Issue

In allocating revenue responsibility, the Commission considers the demand costs and energy costs associated with each class.

Electric utilities incur both fixed and variable costs. The cost of building a generator is generally fixed; they do not change in proportion to the amount of energy generated. In contrast, many operating costs are variable; they change depending on how much the plant is operated. Because a utility must build its plant sufficient to supply the electricity required by customers even on days of peak demand, fixed plant costs are typically regarded as demand-related costs. In contrast, energy-related costs – such as the cost of fuel or electricity purchased from other generators – are typically variable.

But not all energy-related costs are variable. For example, a utility may buy a generator that is expensive to build but uses inexpensive fuel (typical of a “baseload” generator) over a generator that is inexpensive to build but requires expensive fuel (typical of a “peaking” generator). In this case, the choice to incur extra fixed building costs may be understood as a substitute for incurring extra fuel costs.

Whether to characterize costs as related to energy or demand influences class allocations because a utility incurs a different level of demand- and energy-related costs for each customer class. The choice to characterize fixed cost as energy-related benefits the Residential class, for example, whereas the choice to characterize fixed costs as demand-related benefits the C & I Demand class.

2. Position of the Parties

Xcel's rate design allocates plant costs to customer classes using a “stratification method” approved by the Commission in prior rate cases. Under this method, Xcel divides generating plant costs into demand-related costs and energy-related costs. These costs are then allocated to customer classes in proportion to the amount of energy the class consumes and the amount of demand the class imposes on the system. The Large Industrials, however, argue that this allocation method is inefficient and allocates an unwarranted share of fixed costs to their customer class.

³⁴ *Id.*

The Large Industrials asked the Commission to direct Xcel to include a “break-even point analysis” as part of Xcel’s next CCOSS. The study would require Xcel to identify the point at which the savings achieved through building each generator with low fuel costs offsets the fixed costs Xcel might have avoided if it had built a cheaper generator with higher fuel costs. The Large Intervenor argued that this information would permit them to propose a different rate design in Xcel’s next rate case. Xcel, however, opposes the proposal as methodologically unsound and unduly burdensome.

3. Recommendation of the Administrative Law Judge

The ALJ concluded that the Large Industrials failed to show that the break-even point analysis described in the testimony would more accurately determine the cost of serving the respective customer classes. Consequently the ALJ did not recommend ordering Xcel to include a break-even point analysis in its next cost study.

4. Commission Action

The Commission concurs in the ALJ’s analysis. Xcel’s stratified method of allocating plant cost between energy- and demand-related components is well developed and well litigated.³⁵ Based on the record of the case, the Commission is not persuaded that the benefit of having a break-even point analysis would warrant the burden of generating it. The Commission will decline to require Xcel to conduct the requested study.

Note that this decision addresses only Xcel’s duty to produce a break-even point analysis. Nothing in this Order should be construed to prejudice the merits of such an analysis, or to prohibit the Large Industrials from conducting and presenting such an analysis in the future.

C. Commercial & Industrial Sub-Classification

1. Background and Issue

There are many ways in which a utility might choose to divide customers into classes. Historically, Xcel has had multiple commercial and industrial classes with different rates for firm and interruptible service and various discounts based on delivery voltage levels. For purposes of conducting its CCOSS, Xcel combined those subclasses into a single C & I Demand Class. Nevertheless, Xcel’s cost study has the capability to show costs disaggregated into subclasses.

The Large Industrials asked the Commission to direct Xcel to maintain this information and file it in Xcel’s next rate case.

2. Position of the Parties

The Large Industrials argue that they need to see cost information disaggregated into more narrow customer classes in order to make appropriate judgments about rates for subcategories of the C & I

³⁵ See *In the Matter of the Application of Northern States Power Company for Authority to Increase its Rates for Electric Service in the State of Minnesota*, Docket No. E-002/GR-91-1, FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER (November 27, 1991) (the Commission has approved the use of the Stratified allocation method since 1977).

Demand class. Xcel opposed the Large Industrials' request as inappropriate.

Xcel opposed this request, arguing that it should be permitted to design its cost studies in a manner that supports the rate categories it deems appropriate. But if the Commission intends to grant the Large Industrials' request, Xcel asked the Commission to clarify its expectations. In particular, Xcel asked the Commission to clarify whether it means to require Xcel to continue using the customer class definitions it has used in the past.

3. Recommendation of the Administrative Law Judge

The Administrative Law Judge recommended that the Commission require Xcel to continue to provide cost information for existing rate categories in its next CCOSS so that other parties can determine whether combining subclasses results in a fair allocation of cost.

4. Commission Action

The Commission finds merit in the Large Industrials' request. Given the degree of discretion a utility exercises in defining the boundaries of customer classes and the potential consequences this choice has for a customer's rates, it is appropriate for Xcel to cooperate in providing information relevant to analyzing Xcel's choices.

Consequently the Commission will direct Xcel to file a CCOSS that contains the appropriate subclass information as recommended by the Large Industrials. In this study, Xcel shall continue providing cost information for existing rate categories to permit other parties to analyze whether combining subclasses results in a reasonable allocation of costs. But neither the ALJ's recommendations nor this Order should be construed to prevent Xcel from filing a CCOSS that is consistent with whatever rate design or rate restructuring it may propose in its next rate case.

XIII. Inter-Class Revenue Responsibility

The CCOSS provides one factor among many for the Commission's consideration when determining how much of a utility's cost the utility should recover from each rate class.

A. Revenue Allocation Between Classes

1. Background and Issue

The parties addressed questions of class revenue responsibility in two parts: How much responsibility should each class bear assuming the Commission approves Xcel's proposed revenue requirement? And how should this allocation change if the Commission approves a different revenue requirement?

The Commission will first address how to allocate costs among classes assuming Xcel is authorized to receive all the revenues it requests.

2. Position of the Parties

Parties proposed a variety of methods for allocating class responsibility, assuming the Commission were to grant Xcel its requested revenue requirement.

The Energy CENTS Coalition and RUD-OAG proposed allocating any increase in Xcel's revenue requirement uniformly over the rate classes. For example, if the Commission were to authorize Xcel to recover an additional 8%, these parties would support increasing each customer class's responsibility by 8%. RUD-OAG argued that allocating the burden of Xcel's rate increase on a uniform basis would be fairest. Moreover, it would help ensure affordable rates for people with the least ability to pay.

According to RUD-OAG, other customer classes have the ability to pass through any cost increase through charging higher prices for goods and services and through deducting the added expense on their taxes; residential consumers generally lack these opportunities. Finally, RUD-OAG notes that the ALJ favors maintaining the allocation approved by the Commission in Xcel's last rate case,³⁶ as opposed to allocating more costs to the residential class.

In contrast, the Chamber of Commerce proposed that the class revenue responsibilities track the CCOSS perfectly. This allocation would best fulfill the goal of setting cost-based rates based on an embedded cost study and would send the appropriate price signals to promote conservation, according to the Chamber. The Chamber questioned the extent to which some commercial and industrial customers can absorb higher energy bills, and noted that not-for-profit firms and commercial firms that failed to earn a profit would not be able to deduct additional energy costs.

Xcel proposed assigning class responsibility based on both cost and non-cost factors, including the desire to maintain rate stability and concern for affordability. Xcel proposed to allocate responsibility in a manner that roughly maintains the same level of subsidy for the residential class that the Commission approved in Xcel's last rate case. Evolving throughout the course of the rate case, Xcel's final proposal involved allocating costs among five customer classes as follows:

Class	Class Revenue Increase	Class Revenue Responsibility
Residential	10.9%	36.6%
C & I Non-Demand	10.1%	4.0%
C & I Demand	6.1%	58.1%
Municipal Pumping	7.4%	0.3%
Lighting	9.2%	1.1%
	8.0%	100.0%
	(weighted average)	

Xcel proposed maintaining the Demand Metered Class's exemption from the demand ratchet, and instead permitting that class of customers to buy electricity according to the terms of the equivalent general service rates approved in this proceeding. Xcel initially opposed continuing the practice of providing electricity to the small municipal class at a discounted rate. However, Xcel ultimately agreed to support retaining half the existing discount with the understanding that the parties would

³⁶ See ALJ Report at ¶ 199.

work toward developing a different municipal pumping rate structure for Xcel's next rate case. This position was supported by the Commercial Group, the Department, the St. Paul Board of Water Commissioners and the Suburban Rate Authority.

The Large Industrials largely supported Xcel's proposed allocation, but recommended dividing the C & I Demand class into multiple subclasses. Furthermore, they recommended that Xcel limit the increase of rates for the largest customers to 3%, recovering the balance of the revenue requirement from the Residential class and other C & I Demand sub-classes on the theory that this allocation would more closely reflect Xcel's cost of service.

3. Recommendation of the Administrative Law Judge

The ALJ rejected as incomplete any analysis for allocating revenue responsibility that failed to address both cost factors and non-cost factors. While the Commission must exercise judgment in making the trade-off between cost and non-cost factors, the ALJ noted with approval Xcel's testimony that its proposed allocation would maintain roughly the same trade-off as the Commission approved in Xcel's last rate case. Consequently the ALJ recommended using Xcel's proposal for defining customer classes and allocating responsibility for recovery of Xcel's revenue requirement.

4. Commission Action

Both cost and non-cost factors play a role in the Commission's analysis of appropriate class allocations. Cost-based rates promote the goal of allocating costs to those who cause them. Constant rates promote the goal of predictability. And low rates promote the goal of affordability. Because the Commission cannot achieve all these goals simultaneously, the Commission must balance them in allocating responsibilities among rate classes.

The Commission finds that the ALJ appropriately considered and balanced the relevant factors in reaching her recommendation. Consequently the Commission will approve the class definitions and class allocation proposal supported by Xcel, Commercial Group, the Department, the St. Paul Board of Water Commissioners and the Suburban Rate Authority as a "reasonable starting point for determining the revenue allocation of the Commission-approved final revenue requirement."³⁷

B. Adjustments to Revenue Allocation if Lower Revenue Requirement Found

1. Background and Issue

Given that the Commission has not approved Xcel's proposed revenue requirement, the Commission must address how it will adjust the class allocation formula to reflect this fact.

2. Position of the Parties

Parties proposed a variety of methods for allocating responsibility among the customer classes for recovering Xcel's revenue requirement.

³⁷ ALJ Report at ¶ 196.

The Department proposed using the same allocation regardless of the revenue requirement the Commission ultimately approves. If the Commission granted Xcel a smaller increase than Xcel requested, the Department would propose reducing the revenues required of each class proportionately. That is, the Residential class would still be responsible for 36.6% of the total revenue requirement, regardless of the size of the revenue requirement; the C & I Non-Demand Class would still be responsible for 4.0%; and so on. This policy would preserve the appropriate balance of cost and non-cost factors discussed above.

In contrast, the Chamber of Commerce, the Commercial Group, the Large Industrials and Xcel proposed using a lower revenue requirement as an opportunity to move class responsibilities closer to cost. In particular, the Commercial Group, the Large Industrials and Xcel proposed reducing each class's responsibility by the difference between the overall percentage requested and the overall percentage increase approved by the Commission. For example, if the Commission were to approve a 5% increase in the revenue requirement, as opposed to the 8% sought by Xcel, the revenue allocation for each class would be reduced by 3%. Thus, Xcel would increase its revenues from the Residential class by $10.9\% - 3\% = 7.9\%$; from the C & I Non-Demand class by $10.1\% - 3\% = 7.1\%$; and so on.

C. Recommendation of the Administrative Law Judge

Acknowledging that the two adjustment methods advocated by the parties produced similar results, the ALJ nevertheless recommended adoption of the Department's proposal. The ALJ noted that the Department's adjustments would maintain the relationship of rates to costs that the Commission approved in Xcel's last rate case. Also, the Department's proposal would result in a slightly smaller percentage of the revenue requirement being assigned to the Residential class. Given the increasing energy costs that all customers have and will continue to face and the hardship that these costs will impose on low income customers, the ALJ sees merit in erring on the side of caution where residential ratepayers are concerned.

D. Commission Action

The Commission concurs in the ALJ's recommendation. While the Commission appreciates the arguments supporting cost-based rates, the Commission is not persuaded that those arguments carry any additional force simply because Xcel's revenue requirement proves to be less than Xcel requested. The same reasons that prompted the Commission to approve Xcel's allocations assuming the Commission granted Xcel all the revenues Xcel requested also prompt the Commission to maintain this allocation in the face of a smaller revenue requirement.

In short, Xcel's new rates will be designed to recover appropriate revenues from each customer class. Based on the record of this case, the Commission will direct Xcel to recover 36.6% of its revenues from the Residential class, 4.0% from the C & I Non-Demand class, 58.1% from the C & I Demand class, 0.3% from the Municipal Pumping class, and 1.1% from the Lighting class.

XIV. Fuel Clause Adjustment Issues

A. Background and Issue

Generally, this rate case will fix the rates that Xcel charges for electricity – designed to permit Xcel to recover anticipated fixed and variable costs – until Xcel's next rate case. For certain costs, however, the Legislature allows utilities to adjust their rates continuously to reflect changes. In

particular, energy utilities may automatically adjust their rates to pass through changes in the cost of fuel or purchased power via a mechanism called the fuel clause adjustment (FCA).³⁸ The FCA permits the Commission and all parties to avoid frequent rate cases and earnings reviews that might be triggered each time the cost of energy fluctuated.

FCAs reflect, on a per kilowatt-hour basis, deviations from the base cost of energy established in the utility's most recent general rate case. Rates include an energy cost component calculated in the general rate case by determining system-wide costs for fuel and purchased power and then allocating these costs among customer classes. Consequently, Xcel customers receive a utility bill that states both the amount the customer will pay according to the "base rates" set forth in Xcel's tariff, and the amount by which certain costs (including the cost of energy) deviated from the amount reflected in those base rates.

B. Positions of the Parties

1. Xcel

Xcel has proposed a number of changes to its fuel clause rider (FCR). First, Xcel proposed changing the way energy-related costs are reported on a customer's bill. Rather than listing the customer's bill as calculated based on base rates, and then listing the energy-related adjustment to those rates, Xcel also proposed to state a customer's energy-related costs in one sum, and state the remainder of the customer's electricity costs separately. Xcel maintained that this format would provide customers with more information than previously available on customer bills.

Xcel also proposed to use its E8760 allocator, discussed above, to allocate energy-related costs among the customer classes. Xcel initially proposed recalculating this allocator annually to reflect changes in customer's usage patterns and energy-related costs, but in response to party concerns Xcel agreed to use the E8760 allocator calculated based on the data in the record until its next rate case.

2. The Department

The Department did not oppose Xcel's proposal to show fuel costs as a one-line item on a customer bill.³⁹ The Department recommended, however, maintaining the current two-step FCR mechanism, which set a specific level of fuel costs to be recovered in base rates. The Department expressed concern regarding the resultant ratepayer impact of Xcel's proposed one-step method, as well as possible variances needed to implement Xcel's proposal. Finally, the Department argued that it is premature to adopt Xcel's one-step proposal which removes a level of fuel costs from base rates at the present time, as Xcel has not shown its proposal ready for adoption.

³⁸ Minn. Stat. § 216B.16, subd. 7.

³⁹ See, e.g., *In the Matter of the Petition by Northern States Power Company d/b/a Xcel Energy to Separate the Fuel Clause Adjustment from the Resource Adjustment*, Docket No. E-002/M-02-2097, Order Accepting Proposal as Modified (January 4, 2005).

3. RUD-OAG and ECC

The RUD-OAG and the ECC objected to use of the E8760 allocator in that the fuel clause tariff, for reasons identical to those raised in their analysis of the CCOSS, discussed previously. They argued that it is similar to a time-of-use rate, and unfair to the residential class of customers, which is unable to shift its use to the off-peak period.

C. Recommendation of the Administrative Law Judge

According to the ALJ, no party objected to permitting Xcel to list its energy-related costs separately from the rest of its costs on a customer bill, provided that Xcel continues to calculate a customer's bill based on base rates and adjustments.

The ALJ concluded that the E8760 allocator is more accurate than the E20 allocator for identifying the energy-related costs Xcel incurs to meet each customer class's needs.

Finally, if parties seek further refinement to Xcel's FCA mechanism, the ALJ recommended that parties address the matter in a separate docket.

D. Commission Action

The Commission accepts and adopts the findings, conclusions and recommendations of the ALJ. The Commission will require Xcel to maintain the current fuel/energy base charge and separate monthly fuel/energy adjustment calculation and monthly filing mechanism.

The Commission will also permit Xcel to show the fuel/energy charge in one separate charge on the customer bill, combining base fuel/energy charge and monthly FCA into a single line item, separate from the base tariffs. The Commission bases its decision on three factors, as set forth below.

First, the Commission finds merit in Xcel's proposal for changing the way billing information is presented to customers. Both base rates and adjustments reflect useful information. Base rates – combining both energy-related and other costs – provide customers with a basis for estimating future bills based on energy consumption.

Second, the Commission finds that it is important for regulators to monitor adjustments to base rates. In addition, the average customer will likely benefit more from observing their total energy-related costs than from learning how those costs differed from the Commission's projections in the last rate case. Xcel's proposal to modify its bill format will be approved.

Finally, the Commission finds the E8760 allocator to provide a more accurate reflection of class costs than the E20 allocator, for the reasons previously stated. RUD-OAG's concerns about the allocator's complexity and uncertain rate impact were stronger when Xcel was proposing to recalibrate the E8760 annually. But Xcel's subsequent agreement to hold the E8760 allocator fixed mitigates these problems.

For the aforementioned reasons, the Commission will approve these two FCA-related changes. Furthermore, the Commission will direct Xcel to make a compliance filing seeking Commission approval of its method for separating its fuel and energy costs from its base rates, and for presenting this information on a customer bill.

XV. Dual Feeder Service Rates

A. Positions of the Parties

1. Xcel

Xcel asserted that a very small number of its customers (about 160) have very high reliability requirements, and can reduce or avoid the risk of an extended outage by having Xcel install a second, or duplicate, distribution feeder path. When customers request dual feeder (DF) service, the Company either builds new and/or reserves existing feeder facilities. Xcel averred that if DF facilities come from extant system reserves, Xcel replaces them within approximately a year's time.

Xcel proposed no change to the physical characteristics or the terms and conditions of its existing DF service. Instead, Xcel proposed to raise its rates that apply to new DF customers, to recover up-front construction costs for reserved feeder capacity and on-going operating costs for switchgear, alternate feeder construction and reserved feeder construction.

Xcel argued that there would be no double recovery as a result of the new charges. The Company asserted that new DF customers would actually pay the costs of the replacement feeder facilities, modified by a time-value of money adjustment to reflect the delay in construction.

2. The Department

The Department urged the Commission to reject Xcel's proposal. The Department argued that Xcel's proposal is nearly identical to Xcel's 2005 filing on DF that the Commission rejected in 2005.⁴⁰

The Department also argued that Xcel appears to have overstated its operations and management charges by inclusion of costs not directly related to the provision of DF service and failure to show that its proposal to "reserve" existing capacity for a DF customer would not jeopardize reliability of service to customers not on DF service.

The Department argued that Xcel has failed to provide evidentiary support for its proposed change in rates, pointing to Xcel's response to an information request made by the Large Industrials, where Xcel acknowledged that "[n]o particular document or work papers were relied upon or necessary to draw this conclusion."⁴¹

The Department further argued that Xcel never rebutted the Department's allegation that the proposed charge for reserved feeder capacity would result in double recovery, instead merely relying on unsupported assertions that it will not occur. The Department argued that Xcel essentially acknowledged that the reserved feeder capacity is already included in rate base. Thus, the Department concluded that if allowed to charge both base rates and DF customers for these facilities, the Company would receive double recovery for these facilities' costs.

⁴⁰ *In the Matter of a Petition by Northern States Power Company d/b/a Xcel Energy to Modify the Special Facilities Provisions of the Standard Installation and Extension Rules*, Docket No. E-002/M-05-113, Order Rejecting Petition (July 27, 2005).

⁴¹ Xcel's Response to Large Industrial Information Request No. 62.

3. Minnesota Chamber of Commerce and Large Industrials

The Chamber recommended that the Commission reject Xcel's proposal, relying on the Department's rationale that approval of the DF service would be both unfair and provide Xcel with double recovery of certain expenses. The Chamber urged recognition that only within a very narrow factual scenario would such service be appropriate.

The Chamber argued that charges under the service are not just and reasonable as required by Minn. Stat. § 216.03, and any doubt as to reasonableness in rates should be resolved in favor of the consumer. The Chamber articulated its reasons in support of rejection of Xcel's proposal, including, *inter alia*:

- 1) Since feeder capacity constantly changes and is shared with others in varying proportions over time, a customer paying for a feeder extension (whether single or dual feed service), is likely paying for future use by others;
- 2) At times, capacity from an entire feeder system can be required to serve other customers due to emergency needs; and
- 3) There is no exclusive dedication of feeder for any time period that can reasonably be associated with a customer's long-term, up-front capital investment. Shared aspects of feeder maintenance and emergency switching indicate that a feeder designated as exclusively assigned for backup use by a particular customer is not truly reserved for the exclusive use of that customer.

The only concern raised by the Large Industrials was that the DF service rate should not apply where the customer needs additional facilities simply to receive standard service. Xcel agreed that no additional charge would be made for the provision of standard service.

B. Recommendations of the Administrative Law Judge

The Administrative Law Judge found Xcel's proposal for DF service to be reasonable. The ALJ determined that the reserved feeder capacity charge is similar to an alternate feeder charge, in that the new customer is actually paying the cost of new feeder facilities, but on a delayed basis. The ALJ found that although the specific facilities dedicated to the customer existed previously in rate base, those facilities are no longer available to all customers and must be replaced. The ALJ also found no double recovery of the up-front charge and nothing inappropriate about charging the new customer the cost of replacing feeder facilities that are no longer available to other ratepayers.

C. Commission Action

The Company bears the burden to show that its proposed rates are reasonable. Here, the Commission, in keeping with the positions of the Department, Chamber of Commerce and the Large Industrials, finds that Xcel has failed to: 1) adequately support its proposed rates; and 2) demonstrate that the proposal does not result in double recovery.

The Commission agrees with the Department that Xcel's instant proposal is nearly identical to the Company's proposition in Docket No. E-002/M-05-113, and should be rejected. In the prior matter, Xcel proposed adding a charge for "reserved feeder" capacity, described by Xcel as the portion of its

distribution network “reserved” for the DF customer’s use, and proposed changes to the charges for ongoing operations and maintenance expenses. In rejecting that filing, the Commission found that Xcel had failed to show that its proposed charges are not already recovered in current rates.

Further, the Commission finds that although Xcel has stated that it will eventually build new distribution facilities, there is nothing in the tariff that would require the Company to invest in any new facilities. Under Xcel’s rationale, ratepayers as a whole could overpay for such facilities from the time Xcel charges the DF customer for reserved capacity until Xcel chooses to build new capacity.

Finally, Xcel has not shown that its proposed charges reflect only the specific costs of providing service to *new* DF customers. Xcel has not persuasively supported in the record presented herein its contention that the proposed charges are not already recovered under current rates.

For the aforementioned reasons, the Commission will again reject Xcel’s request, as it did in Docket No. E-002/M-05-113, regarding DF service.

The Commission will also require Xcel to track the investments needed to provide the service that it has proposed and to specifically reflect those costs in its next rate case.

XVI. Interruptible Rates

A. Positions of the Parties

Xcel filed its interruptible rate schedules, setting forth the rate discounts it provides to customers who agree to allow the interruption of load during peak use. Xcel did not seek to change the current level of control demand discounts for interruptible customers, instead 1) filing interruptible rate schedules to comply with prior Commission orders; update and clarify tariff language; 2) eliminating certain riders that limit the number of customers who can benefit from interruptible rate discounts; and 3) create additional customer groups with smaller blocks of interruptible load to avoid interruptions that go beyond the necessary load relief.

Xcel also proposed a \$60 per MWh threshold for determining when it may call an energy control period, where Xcel can interrupt load when its estimated cost of production or purchases exceeds \$60 per MWh.

The Department supported Xcel’s proposed tariff changes related to interruptible load rate tariffs.

The Large Industrials proposed two changes to Xcel’s interruptible tariffs:

1. Increasing the proposed interruption threshold from \$60 per Mwh to \$70 per MWh related to the Company’s Tier 1 energy controlled service rider; and
2. Increasing the capacity credit to customers under the Tier 1 peak controlled schedule L interruption rider customers by \$1.23 per KW.

Xcel agreed to raise the threshold to \$70, subject to re-evaluation in the next rate case. Xcel also agreed to a \$0.50 increase in the capacity credit for schedule L customers, in lieu of the \$1.23 proposed, and the Large Industrials agreed that this was reasonable. Schedule L customers agree to be interrupted with only a 10-minute notice.

The Chamber of Commerce accepted both changes, consistent with the agreement between Xcel and the Large Industrials. The Chamber argued, however, for a higher interruptible load credit for all customers, on the theory that the current rate discounts fail to reflect the benefits of load interruption on transmission congestion.

In response, Xcel argued that the short-term interruption of load during peak use under the interruptible load tariff addresses generation reserve needs, not transmission congestion. Xcel further argued that it is not able to avoid any transmission facilities; hence there is no basis on which to provide a further discount to interruptible customers. The Large Industrials concurred with Xcel's position on this issue.

B. Recommendation of the Administrative Law Judge

The ALJ recommended that the Commission adopt Xcel's proposed interruptible tariffs, including the higher threshold and discount for schedule L customers, as reasonable. The ALJ found no persuasive evidence in the record that would require an increase in interruptible rate discounts based on transmission savings. The ALJ found that the record failed to establish any nexus between the interruption of peak load and transmission congestion that would merit a further discount.

The ALJ further determined that the Chamber had not supported its case, in that it had not quantified the value of its suggested additional proposed discount or provided a record that would permit the Commission to determine the effect of applying such a discount to other classes of customers.

C. Commission Action

The Commission accepts and adopts the findings, recommendations, and reasoning of the ALJ on this matter and will adopt Xcel's proposed interruptible tariffs, including the higher threshold and discount for schedule L customers.

It has not been demonstrated by substantial evidence in the record that there are substantial savings associated with avoided transmission costs for interruptible customers, and the Commission will therefore reject the Chamber's proposal to reduce interruptible rates to reflect such savings.

Transmission realities continue to evolve, however, as transmission functions are centralized by regional transmission organizations. The Commission will therefore require Xcel to continue to monitor and analyze whether and how interruptibility affects transmission congestion and costs and to report back to the Commission within a year.

XVII. Windsource Tariff and Pricing

A. Positions of the Parties

Xcel proposed six changes to the Windsource program, including changes to the level of the Windsource rate and changes to the method of recovery of costs for the program from all ratepayers. Xcel determined the fuel clause rider credit for Windsource based on average cost. Xcel asserted that

it made its calculations as previously directed by the Commission.⁴² Xcel also argued that the Commission set the methodology to be used in setting the Windsource rate.

Intervenors generally did not object to Xcel's proposed changes.

The Chamber, however, argued that the fuel clause rider credit applied to the Windsource rate is over-priced and should be reduced by crediting it with marginal rather than average fuel costs, thus increasing the amount of credit given to the Windsource rate.

Xcel responded that the Commission should not reconsider one element of a prescribed methodology without reconsidering all other elements. Xcel argued that any such comprehensive review should be undertaken in connection with its annual filings regarding its Windsource rate. Xcel concluded, however, that as no other intervenors in this case recommended that the Commission re-open the broader process for setting the Windsource rate, that the average fuel cost credit should continue to be used.

Xcel also proposed to recover capacity costs related to the Windsource facilities from all ratepayers through an increase in base rates. Xcel justified the recovery from other ratepayers of the avoided capacity costs used to calculate the Windsource rate as follows:

The Company is not recovering any "avoided" capacity costs. The "avoided" capacity costs, by definition were **not incurred** and are not reflected in rates. These costs were avoided due to the "alternative" capacity provided by the Windsource generators. On the other hand, the Company did incur real costs associated with the alternative wind capacity. This cost is embedded in the purchased energy costs of Windsource contracts (approximately ½ cent per kWh). Because the Windsource rate excluded the costs for the alternative wind capacity, that costs needs to be included in the base rates that all ratepayers pay.

The inclusion of this cost in base rates happens automatically as a part of the normal "ratemaking process" as follows. The total costs of the Windsource program (including the capacity costs) are included in the determination of the TY "revenue requirements." These Windsource program revenue requirements are mostly off-set by Windsource rate revenues, which are included in "Other Operating Revenues." However, because of the "capacity cost credit" in the Windsource rate, the Windsource revenues do not cover this capacity cost and the base rate of all ratepayers is automatically set at a slightly higher level thereby recovering this cost. . . . So long as the capacity costs that are avoided (there is no sure way to determine what they actually would have been) are equal to or greater than the ½ cent credit given to Windsource customers, all other ratepayers are "made whole."⁴³

⁴² *In the Matter of Xcel Energy's Petition for Approval of a Renewable Energy Rider*, Docket No. E-002/M-01-1479, Order Approving Renewable Energy Rider as Revised, Clarified, and Modified (May 7, 2002).

⁴³ Xcel response to PUC Information Request 1, May 15, 2006.

B. Recommendations of the Administrative Law Judge

The ALJ agreed with Xcel's position, finding that the Commission's decision to use average rather than marginal costs to determine the Windsource premium rate was reasonable.

C. Commission Action

The Commission accepts and adopts the ALJ's recommendation to retain the current method for pricing (not recovery) of Windsource energy, using an "average fuel cost credit" in calculating the premium. The Commission's prescribed methodology, as previously established in Docket No. E-002/M-01-1479, is sound, and will be utilized here.

The Commission will also adopt the Company's proposal to update recovery of capacity costs by raising base rates to recover Windsource capacity costs. The Commission acknowledges that this is potentially a significant change in the way Windsource capacity costs are recovered. Recognizing this, the Commission will require Xcel to file a compliance filing demonstrating how the Windsource program capacity is integrated with system capacity. In addition, the Commission will require Xcel to show why the pricing of the Windsource rate, including recovery of capacity costs from other ratepayers, is reasonable.

XVIII. Contributions in Aid of Construction

A. Background

Xcel has historically charged customers a Contribution in Aid of Construction (CIAC) for service extensions when the cost of the extension exceeded three times the customer's anticipated annual revenues. In the past, for administrative ease, Xcel has included fuel cost-related revenues in making the calculation, although fuel costs were not directly related to the capital/rate base related costs of providing utility service.

Historically, the inclusion of fuel cost revenues was not problematic because the costs were minimal and stable; however, significant increases in fuel costs have caused Xcel to alter the formula to calculate the CIAC charge.

B. Positions of the Parties

1. Calculation of CIAC

Xcel proposed to modify the tariff to read, "three times the customer's anticipated annual revenues, excluding the portion of the revenue representing fuel cost recovery." Xcel proposed to apply this change to both residential and nonresidential customers. Without the change, all ratepayers, as opposed to the ratepayers requesting the service extension, would pay significantly larger amounts of special investment, due to higher fuel costs.

Xcel's recommendation would increase the formula to 3.5 times revenue (excluding the fuel cost-related revenues), essentially equal to 3.0 times-revenues (including the 1.354 per kWh fuel costs), for residential customers. Xcel demonstrated that its 3.5 times revenue formula yields essentially the same construction allowance as the Chamber's proposal, at test year 2005, as well as what was present in 1993 rates.

The Chamber argued that in order for a customer to be in an equal position with the new rates proposed in this case, a commercial and industrial class customer should receive a multiple 3.94 times annual revenue as the offset for facilities charge based on the cost of fuel built into rates in 2005 of 1.354 cents. The Chamber requested the Commission to round to four (4) times revenue as the appropriate calculation for C & I customers, to keep these ratepayers in the same position as it were in 2005.

In response, Xcel argued that it has never had, and does not recommend establishing, a separate higher “revenue” factor for General Services customers. Xcel has recommended a uniform amount of allowable investment for all customer classes.

In contrast, the Chamber recommended that different customer classes be allowed different levels of investment without incurring a CIAC.

2. Method of Payment of CIAC

Xcel’s tariff allows it to determine the manner of payment for CIAC’s. The alternatives include a single up-front payment, a periodic payment plan, or some combination of the two. Xcel has generally utilized a single up-front payment.

The Chamber proposed that the customer, in lieu of Xcel, be allowed to select which alternative is utilized, or that the rules be revised to specify when each type of payment will be applied.

Xcel opposed the Chamber’s proposal, arguing that its current practice has long been in place, has not been shown to cause problems, and provides the flexibility the Company needs to determine the manner of payments for CIACs.

C. Recommendation of the Administrative Law Judge

The ALJ recommended Xcel’s formula for determining the CIAC charge, finding it reasonable and supported by the record. The ALJ also recommended that the Commission adopt Xcel’s proposal to retain flexibility in the selection of payment alternatives, finding that the record does not suggest that Xcel has been arbitrary or unreasonable in selecting payment alternatives.

D. Commission Action

The Commission will accept and adopt the ALJ’s recommendation to utilize Xcel’s proposed formula for determining the CIAC charge, including the use of a 3.5 times revenue factor. Xcel proposed a uniform formula for determining the amount of CIAC. The Company has never had a separate higher revenue factor for General Service customers, and saw no need to do so now. If Xcel were in fact to differentiate the formula based on customer class, it would not be unreasonable to charge C&I customers more than residential customers.

The Commission is not persuaded by the Chamber’s argument that the 3.5 times revenue proposal is in any way unfair or unreasonable to C&I customers. Based in large part on Xcel’s historic practice of maintaining a uniform formula for determining one CIAC amount, the Commission will adopt the 3.5 times revenue factor.

The Commission also finds that Xcel's position regarding maintaining flexibility as to the method of payment is supported by the record. The payment alternatives utilized have not been shown to cause problems for customers, and the Commission will not infer such evidence based on the record established herein. For the foregoing reasons, the Commission will accept and adopt the ALJ's recommendation and reasoning on this second issue.

XIX. Financial Neutrality Factor

A. Positions of the Parties

Xcel argued that when it invests in conservation improvement programs (CIP) or demand side management (DSM), it lowers its demand for electricity. With such investments, Xcel asserts that it is able to delay or avoid the need to build additional power plants to meet incremental demand. When it invests in CIP instead of building new plants, however, Xcel argues that it loses the theoretical incremental revenues and earnings it would have received from operating the power plant, absent the CIP investments.

Xcel requested that it be compensated for the loss of the theoretical revenue associated with CIP, to encourage it to pursue the expanded DSM goals approved by the Commission in its 2004 resource plan.⁴⁴ Xcel requested a return on the equity portion of its CIP investment, justifying this on the basis that it will result in equal treatment of CIP investment and plant investment. The Company proposed a rider mechanism it identified as the financial neutrality factor (FNF).

Xcel explained that the FNF would be based on the costs of a base load power plant, the cost of equity and capital structure authorized in this rate proceeding, and the achieved demand savings filed in its CIP reports. Xcel iterated that the FNF would reward it for achieving approximately 275 MW more demand savings than the demand-savings goals it would achieve if it were to spend \$43 million per year for the years 2005-2019.

The Department, the RUD-OAG, ECC, Commercial Group and the Large Industrials all opposed Xcel's FNF proposal, arguing that it: 1) was not specifically authorized by Minnesota law; 2) would unreasonably increase customer bills; 3) and would reward Xcel for actions it would have taken anyway.

The Department argued that Xcel's proposal would result in unreasonable rates as the law already allows preferential tracker treatment for recovery of CIP investment, along with an incentive mechanism that reasonably compensates the Company.

The Department further argued that the proposed FNF would not make Xcel indifferent as to conservation versus plant investment, because in addition to the financial risks associated with a construction of a new plant, there is already a greater financial incentive to invest in CIP as Xcel receives timely dollar-for-dollar recovery of its expenses.

⁴⁴ *In the Matter of the Petition of Northern States Power Company d/b/a Xcel Energy's Application for Approval of its 2005-2019 Resource Plan*, Docket No. E-002/RP-04-1752, Order Approving Resource Plan as Modified, Finding Compliance with Renewable Energy Objectives Statute, and Setting Filing Requirements (July 28, 2006).

The Department concluded that the FNF criteria would reward Xcel for meeting demand-side goals it will easily achieve in any event, arguing that the demand-savings threshold under its proposed FNF is actually lower than the Company has been achieving.

B. Recommendation of the Administrative Law Judge

The ALJ explained that while, in her view, a mechanism such as the FNF was technically legally permissible, she concurred with those parties opposing the FNF that the proposed FNF is unreasonably expensive for ratepayers. The ALJ recommended that the Commission reject the FNF, but noted that there was some agreement among the parties that mechanisms like the FNF could be structured to send appropriate economic signals to encourage aggressive efforts to reduce the need for expensive base load generation.

C. Commission Action

The Commission concurs with the ALJ and will reject Xcel's proposal to establish an FNF in this proceeding. The Commission recognizes however, that given the pending need for base load resources, growing environmental concerns, and volatile electricity and fuel prices, that the challenges of meeting future resource needs will certainly be more significant than have been experienced in the past.

In an effort to commence a discussion on these timely and important issues, the Commission will open a comprehensive investigation into Minnesota regulatory policies on conservation, energy efficiency, demand-side management, financial incentive mechanisms, and related issues. The investigation will examine both the effectiveness of current policies and the potential effectiveness of alternative policies.

The Commission requests the assistance of the Department, asking that agency to conduct a preliminary investigation of these issues, and to bring back two sets of recommendations:

- A. Recommendations identifying any new or alternative regulatory models, structures, and policies that appear to hold significant promise for successful adoption or adaption in Minnesota and that therefore merit further examination; and
- B. Recommendations on what action steps, procedural vehicles, and resources are necessary for the Commission to adequately examine the regulatory models, structures, and policies identified above and to ensure the active participation of the broadest possible range of interested stakeholders, constituents, and policymakers, including legislators.

The Commission notes with approval Xcel's willingness to work with the Commission, Commission staff, and the Department, in the development of this investigation and ensuing policy discussions.

XX. Overall Financial Schedules

A. Gross Revenue Deficiency

The above Commission findings and conclusions result in a Minnesota jurisdictional gross revenue deficiency for the 2006 test year of \$131,455,000 as shown below:

REVENUE SUMMARY
Test Year Ending December 31, 2006
(000's omitted)

Rate Base	\$ 3,240,601
Rate of Return	8.81%
Required Operating Income	\$ 285,496
Test Year Operating Income	\$ 208,424
Operating Income Deficiency	\$ 77,072
Revenue Conversion Factor	1.705611
Gross Revenue Deficiency	<u>\$ 131,455</u>

The above Commission findings and conclusions result in a Minnesota jurisdictional gross revenue deficiency for rates effective January 1, 2007 of \$114,941,000 as shown below:

REVENUE SUMMARY
Effective January 1, 2007
(000's omitted)

Rate Base	\$ 3,241,593
Rate of Return	8.81%
Required Operating Income	\$ 285,584
Test Year Operating Income	\$ 218,194
Operating Income Deficiency	\$ 67,390
Revenue Conversion Factor	\$ 1.705611
Gross Revenue Deficiency	<u>\$ 114,941</u>

B. Rate Base Summary

Based on the above findings, the Commission concludes that the appropriate rate base for the test year ending 2006 is \$3,240,601,000 as shown below:

RATE BASE	
Test Year Ending December 31, 2006	
(000's omitted)	
Utility Plant in Service	\$ 8,624,830
Reserve for Depreciation	(5,016,377)
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Net Utility Plant in Service	\$ 3,608,453
Construction Work in Progress	176,918
Plant Held for Future Use	0
Accumulated Deferred Income Taxes	(572,094)
Working Capital	
Cash Working Capital	(15,542)
Materials and Supplies	82,808
Fuel	27,634
Non-Plant Assets & Liabilities	(90,504)
Prepayments	16,973
Other	5,955
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Total Average Rate Base	\$ 3,240,601
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For rates effective January 1, 2007, the Commission concludes that the appropriate rate base is \$3,241,593,000 as shown below:

RATE BASE
Effective January 1, 2007
(000's omitted)

Utility Plant in Service	\$ 8,624,830
Reserve for Depreciation	<u>(5,016,377)</u>
Net Utility Plant in Service	\$ 3,608,453
Construction Work in Progress	176,918
Plant Held for Future Use	0
Accumulated Deferred Income Taxes	(572,094)
Working Capital	
Cash Working Capital	(14,550)
Materials and Supplies	82,808
Fuel	27,634
Non-Plant Assets & Liabilities	(90,504)
Prepayments	16,973
Other	<u>5,955</u>
Total Average Rate Base	<u><u>\$ 3,241,593</u></u>

C. Operating Income Statement Summary

Based on the above findings, the Commission concludes that the appropriate Minnesota jurisdictional operating income for the 2006 test year under present rates is \$208,424,000 as shown below:

OPERATING INCOME STATEMENT
Test Year Ending December 31, 2006
(000's omitted)

Revenues:

Retail Revenues	\$ 2,094,502
CIP Revenue Adjustment	(13,075)
Interdepartmental	923
Other Operating	544,717
Total Revenues	<u>\$ 2,627,067</u>

Expenses:

Production, Fuel, Purchased Power	\$ 1,500,612
Transmission	103,110
Distribution	80,717
Customer Accounting	42,205
Customer Information	46,562
Administrative & General	147,125
Other Expense	121
Depreciation & Amortization	355,332

Taxes:

Property	95,690
State & Federal Income	68,174
Deferred Income	(16,999)
Other	16,714

Total Expenses	<u>\$ 2,439,363</u>
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Income Before AFUDC	\$ 187,704
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AFUDC	<u>20,720</u>
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Income With AFUDC	<u><u>\$ 208,424</u></u>
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The Commission concludes that the appropriate Minnesota jurisdictional operating income effective January 1, 2007 is \$218,194,000 as shown below:

OPERATING INCOME STATEMENT

Effective January 1, 2007

(000's omitted)

Revenues:

Retail Revenues	\$ 2,133,897
CIP Revenue Adjustment	(13,075)
Interdepartmental	923
Other Operating	544,717
Total Revenues	<u>\$ 2,666,462</u>

Expenses:

Production, fuel, purchased power	\$ 1,523,368
Transmission	103,110
Distribution	80,717
Customer Accounting	42,205
Customer Information	46,562
Administrative & General	147,125
Other Expense	121
Depreciation & Amortization	355,332

Taxes:

Property	95,690
State & Federal Income	75,043
Deferred Income	(16,999)
Other	16,714

Total Expenses	<u>\$ 2,468,988</u>
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Income Before AFUDC	\$ 197,474
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AFUDC	<u>20,720</u>
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Income With AFUDC	<u><u>\$ 218,194</u></u>
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XXI. Compliance Filings Required

The Commission will require the Company to make a compliance filing within 30 days of the date of this Order showing the final rate effects of the decisions made here and proposing a plan for refunding the difference between the amounts it collected in interim rates and the amounts it is authorized to collect in final rates. The Commission will establish a brief comment period to give interested persons a chance to review and comment on that filing.

The Commission will so order.

ORDER

1. Xcel's Electric Utility is entitled to increase gross Minnesota jurisdictional revenues by \$131,455,000 to produce gross jurisdictional total retail related revenue of \$2,213,805,000 for the test year ending December 31, 2006. Beginning January 1, 2007, the authorized increase is adjusted to \$114,941,000 to produce gross jurisdictional total retail related revenue of \$2,236,686,000.
2. The Commission accepts and adopts the findings, conclusions, and recommendations of the Administrative Law Judge, except as set forth herein.
3. The Commission accepts and adopts the Company's correction to the Administrative Law Judge's calculation to reflect a reduction in test year annual incentive compensation expense of approximately \$3,929,000.
4. In its next general rate case, the Company shall continue to provide cost information for existing rate categories to permit other parties to analyze whether combining subclasses results in a reasonable allocation of costs.
5. Nothing in the Administrative Law Judge's Report or this Order may be properly construed to prevent the Company from filing a Class Cost of Service Study that is consistent with whatever rate design or rate restructuring it may propose in the next rate case.
6. In its next general rate case, the Company shall file a primary Class Cost of Service Study that contains the appropriate subclass information as recommended by the Large Industrials.
7. The Company shall track the investments required to provide Dual Feeder service and shall report on those costs in its next general rate case.
8. Within twelve months of the date of this Order the Company shall make a filing analyzing whether there are transmission savings associated with interruptible service that ought to be reflected in interruptible rates.
9. The Commission hereby opens an investigation to evaluate Minnesota regulatory policies on conservation, energy efficiency, demand-side management, financial incentive mechanisms, and related issues, investigating both the effectiveness of current policies and the potential effectiveness of alternative policies. The Commission asks the Department of Commerce to conduct a preliminary investigation of these issues, with the support and assistance of Commission staff, and to report back as promptly as possible with two sets of recommendations:
 - (A) recommendations identifying any new or alternative regulatory models, structures, and policies that appear to hold significant promise for successful adoption or adaptation in Minnesota and that therefore merit further examination; and

- (B) recommendations on what action steps, procedural vehicles, and resources are necessary for the Commission to adequately examine the regulatory models, structures, and policies identified above and to ensure the active participation of the broadest possible range of interested stakeholders, constituencies, and policymakers, including legislators.
10. As a compliance requirement in this docket, the Company shall make a filing demonstrating how its Windsource program capacity is integrated with system capacity and setting forth the reasons that the pricing of the Windsource rate, including recovery of capacity costs from other ratepayers, is reasonable.
 11. The Commission adopts the modification to the Mandatory Time of Day Tariff applicable to customers with usage exceeding 1,000 kW to require a nine-month implementation delay as part of this tariff.
 12. The Commission recognizes the Company's commitment to work with the Saint Paul Regional Water Services, the Suburban Rate Authority, and the Chamber of Commerce on aggregation issues. Within ten months of the date of this Order, the Company shall make a filing reporting on the status of these efforts.
 13. Within one year of the date of this Order, the Company shall make a filing reporting on any additional improvements to its CRS billing system data.
 14. At least 30 days in advance of the date of its next gas or electric general rate case filing, the Company shall make a filing providing the data used in its test year sales forecasts.
 15. In preparing its next general rate case, the Company shall use an accepted industry standard approach to developing econometric models, and shall include the most current economic and demographic data available at the time of modeling. The Company shall continue to work with the Department of Commerce on forecasting issues.
 16. The Company shall continue to work with the Department of Commerce on the development of new tools for its revenue model and to determine if the Company can create the linkage sought between competing revenue models without losing the flexibility of other efforts in the areas of forecasting and the Class Cost of Service Study. The Company commits to work with the Department on the development of a more integrated approach prior to its next general rate case filing.
 17. Within 30 days of the date of this Order, the Company shall file with the Commission, for its review and approval, and shall serve on all parties to this proceeding, a compliance filing implementing the decisions made herein and containing at least the following items:
 - A. Revised schedules of rates and charges reflecting the revenue requirement and the rate design decisions herein, along with the proposed effective date, and including the following information:
 1. A breakdown of Total Operating Revenues by type.
 2. Schedules showing all billing determinants for the retail sales (and sale for resale) of electricity, including but not necessarily limited to the items set forth below.

3. Total revenue by customer class.
 4. Total number of customers, the customer charge and total customer charge revenue by customer class.
 5. For each customer class, the total number of energy and demand related billing units, the per unit energy and demand cost of electricity, the non-electricity unit margin, and the total energy and demand related sales revenues.
 6. Revised tariff sheets incorporating authorized rate design decisions.
 7. Proposed customer notices explaining the final rates and the monthly basic service charge.
- B. For the test year and effective January 1, 2007, a revised base cost of energy and supporting schedules incorporating any changes made as a result of this rate case, and calculations establishing the proper adjustments to be in effect at the time final rates become effective.
 - C. For the test year and effective January 1, 2007, a calculation of the Conservation Improvement Program (CIP) conservation cost recovery charges (CCRC) based on the decisions made herein and schedules detailing the CIP tracker balance at the beginning of interim rates, the revenues (CCRC and CIP Adjustment Factor), and costs recorded during the period of interim rates, and the CIP tracker balance at the time final rates become effective.
 - D. Copies (revised as necessary) of all standard customer service agreements and contracts for inclusion in the Company's tariff book.
 - E. A proposal to make refunds of interim rates, including interest calculated at the average prime rate, to affected customers.
18. Comments on the filing required under paragraph 6 shall be filed within 30 days of the date of the filing.
 19. This Order shall become effective immediately.

BY ORDER OF THE COMMISSION

Burl W. Haar
Executive Secretary

(S E A L)

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